

Claes Brundenius  
Ricardo Torres Pérez *Editors*

# No More Free Lunch

Reflections on the Cuban Economic Reform  
Process and Challenges for Transformation

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# Foreword

## **Cuba: An Economy Careening Forward, Destination Unknown**

Cuban President Raul Castro envisions a radically different economic landscape in Cuba from that which he inherited from his brother in 2006. Almost as soon as Fidel withdrew from the scene due to grave illness, his younger sibling, whose commitment to the half-century-old revolution is beyond question, articulated a series of critiques of the prevailing state of affairs that resonated widely on the island and beyond: Cuba's economy was in shambles, sclerotic and unproductive, and incapable of providing the citizenry with minimal goods and services (R. Castro 2010). Even the much-vaunted health and educational systems, signature achievements of the revolution, were eroding, imperiled by the failure to generate anywhere near the levels of production needed to sustain the population and the state (Hershberg 2011). Fidel Castro himself, emerging from protracted absence caused by serious illness, declared that the Cuban model of socialism was no longer viable (Goldberg 2010). For some Cuban citizens and outside observers the pace of reforms under Raul has been disappointing, with every two steps forward followed by frustrating delay or even by one step in reverse. Contributors to this timely volume document thoroughly both the content of the reforms and their early impacts, as well as some of the controversies they have engendered. While the end point of liberalization cannot yet be determined, the decision to abandon five decades of precedent is abundantly clear and is already palpable on the streets of every Cuban city and in farms and rural areas across the country.

To know that one is abandoning the past is not necessarily to know where one is going, and the situation in Cuba today bears this out. It is imprudent when contemplating Cuban affairs to use the term inconceivable. The 1959 revolution itself was inconceivable to all but the most believing of advocates well into 1958. The fall of the Soviet Union was characterized as an "inconceivable" occurrence when Fidel Castro reflected on the phenomenon in his July 26, 1993, speech to a population

experiencing the hardships and shock of economic free-fall (Castro Ruz 1993). And for some of the revolution's critics, it was inconceivable that political stability would persist long after Fidel's departure from the scene and appear likely to endure for the foreseeable future (Oppenheimer 1993; Powell 2004). Notwithstanding these infelicitous precedents, I think that by now one can venture the prediction that a reversal of the trajectory of economic reforms in Cuba is, well, inconceivable. It is an entirely different matter, however, to foresee with any certainty what character the reforms will assume during the coming years or to predict where they will leave the country once Raul Castro, an octogenarian himself, departs the scene.

Some visitors to the island are tempted to look at Cuba's predicaments, opportunities and incipient reforms, and conclude that the country will wind up in a place rather like that which awaited other economies that launched transitions from central planning during the last decade or so of the twentieth century. I recall conversations during the 1990s with East Europeanist academics who, after spending a few days on the island, invariably expressed their convictions, conveyed with great certainty, about where Cuba was headed and what it would look like as it advanced inexorably along the path of countries such as Hungary or Poland. I have come across more than one China specialist prepared to inform Cubans that after you do this, this will happen, after which you will do that, and the other will happen, and then you will end up here or there. We've seen what has happened as Communist regimes move from plan to market, the story goes, and we can tell you what will transpire as you do the same.

At one level, it makes sense to look at experiences elsewhere to gain purchase on the likely course of events in a setting that replicates features of contexts already known. Social scientists gain invaluable insights through the use of most-similar system research designs. By considering Cuba's prospects in light of the patterns of change that have unfolded in Vietnam, in particular, contributors to this volume take advantage of a valuable opportunity to gain insight into waters that, for this unique island, are uncharted. The exercise is valuable, so long as one does not leap to the conclusion that where other countries ended up is where Cuba is inevitably headed. To their credit, the authors of this book resist this temptation. They know that lessons from elsewhere generate insight, but that assumptions that one country necessarily will replicate the course of another are hazardous, and more frequently than not misguided. Nowhere is this cautionary note more apt than with regard to predictions regarding Cuba, a country that at first glance is but a mere blip on the map of the globe but one that has played an outsized and distinctive role in the history of the world over the past half century.

My intention here is not to fall into the trap of Cuban exceptionalism (Kapcia 2008), and indeed it would be the height of folly to ignore the degree to which Cuba's challenges are ultimately the same as those that face every country in the world. States require legitimacy if they are to function for more than transitory periods, and economies must generate enough wealth to ensure the population's capacity to reproduce itself and, ultimately, the capacity of the state to preserve legitimacy. Marx and Engels and many of their disciples understood these points quite well, and so does Raul Castro. The reforms that he has spearheaded cannot be comprehended

absent recognition of these basic principles of political economy. But how those reforms unfold, their pace and ultimate destination, will be the result of factors that reflect Cuba's singular trajectory, its unusual geopolitical circumstances, and the peculiarities of its domestic politics. The destination of the reforms will hinge as well on their success in overcoming the desperate state of affairs that has propelled the winds of change. It is still early days in what is certain to be a protracted process.

One point that has to be underlined in assessing how other experiences of transition from central planning inform understandings of where Cuba may be headed is that there is no evidence to suggest that part of the agenda involves simultaneous political transition. This has profound implications, as suggested by Oscar Fernández Estrada in his contribution to this book. As in China and Vietnam, and unlike what we witnessed in much of the former Soviet bloc, political transformation is not the intention of the country's leaders—far from it. Arguably, no factor is more important to understanding the motivation behind the reforms, the logic of their content, and their severe limitations, than the determination of Raul Castro and his team to maintain their monopoly on political power and to facilitate a transition to a new generation of leadership that will preserve the regime bequeathed to them. That the latter is an important consideration is evident from Raul's pledge at the 2012 Party Congress to enact term limits following his own reappointment, a measure that may foster enthusiasm in some quarters even while skeptics will claim that it obeys no principle beyond that of actuarial logic. That the task will be challenging is reflected in the fact that the median age of the Politburo appointed in 1997 was 54, while in the wake of the 2011 Congress the median age of this crucial leadership body had risen to 70 years of age (Dominguez 2012:15).

Geopolitical and geographic context are additional factors that set Cuba apart from experiences of transition elsewhere. To be sure, antagonism from the United States was a common experience of virtually all socialist systems. Vietnam in particular will forever be scarred by the consequences of its confrontation with the capitalist superpower. But Cuba is unique in that the process of economic reforms is unfolding without a reduction in the half-century-old standoff with the USA. From the perspective of Havana, the Cold War has not ended. This is all the more significant given Cuba's location. Not only does the embargo constrain Cuba's economic options, but whereas socialist countries in Asia saw their economies propelled following economic reforms by a dynamic regional market and increasingly integrated production chains, Cuba cannot draw on analogous engines for economic growth. Not only is the country unable to engage its most natural developed country trading partner and confronted with inflated transportation costs, but more importantly the embargo constrains potential investors and trade partners from elsewhere, who might desire stronger ties with Cuba but fear the impact of provisions such as the Helms-Burton Law, which imposes draconian costs on firms of any nationality that do business in Cuba.

Demographic characteristics also make Cuba's situation exceptional. On the one hand, its population is better educated than that of any country that has launched a liberalization of a command economy. A highly educated population might in principle constitute the greatest advantage enjoyed by Cuba in comparison to either



Vietnam or China, as several contributors to this volume emphasize, for it opens the possibility that a transformed economy could specialize in high value-added activities that would bolster incomes for both citizens and the state. This is all the more important given the rapidly aging Cuban population: the combination of persistently low birth rates, substantial outward migration, and high life expectancies has increased dependency ratios to alarming levels. Thus, in contrast to China and Vietnam, which could prosper in part by incorporating growing percentages of their populations into productive activities, the only way for Cuba to provide reasonably acceptable levels of support for the nonworking population is to maximize the productivity of the minority of Cubans who participate in the workforce.

This imperative brings us back both to the content of the reforms and to the capacity of the Cuban system to implement them. To date, there is little evidence that Cuba's leadership is fashioning the reforms in such a way as to unleash productive energies in high value-added sectors. Quite the contrary, they are confined to low-productivity niches, with the ossified state retaining control of those areas of the economy that would have to be central components of a dynamic, wealth-generating Cuba. At first glance, agriculture might appear to be an exception, but as Garcia's contribution to this book and other analyses underscore (Perkins 2012), the performance to date has been deeply disappointing. Plagued by infrastructural and institutional deficiencies and by the actions of a state that seems unwilling to cede control over an array of coordination functions, Cuban agriculture continues to decline despite a host of liberalization measures. The failure to decentralize authority in the comparatively simple agricultural sector—the failure to enable basic markets to work—calls into question whether Cuba's institutional fabric can be adapted to the task of promoting the essential capabilities for speedy, autonomous, and flexible responses to economic change on the part of a highly skilled workforce and knowledge-intensive enterprises.

To contribute effectively to the processes of high-road economic growth, strong institutions are necessary, but the strength of institutions needs to be measured in terms of their agility and their capacity to empower actors to deploy their skills and know-how autonomously. Stated differently, institutions need to minimize transaction costs, rather than create layers of inefficiency that stifle innovation and (individual or collective) initiative. To the extent that this is so, Cuba and other countries that have made substantial investments in human capital formation will be able to reap the rewards of those investments only if they manage to create institutional environments that facilitate that end. Where such institutions are lacking, or where the institutional context discourages innovation, those investments are unlikely to pay off in competitive success. An even more troubling possibility is that this disjuncture will exacerbate "brain drain," depriving Cuba of future generations of entrepreneurs, knowledge workers, and intellectuals who are needed to spearhead efforts to gain desirable modes of insertion into the global economy.

The long-awaited announcement in January, 2013, that almost any Cuban citizen is free to travel abroad without having to secure an exit permit might at first glance seem to accentuate this risk, but arguably it is instead a wise move that holds the potential to generate considerable benefits for the economy and society.

China today is reaping the benefits of “brain gain,” as highly trained entrepreneurs, many having been trained abroad, catapult the economy toward the cutting edge of one industry after another. Whether Cuba’s reforms eventually lead to such a felicitous outcome will be determined in part by whether the reforms enable its most-talented citizens to imagine a future for themselves on the island, and whether the descendants of Cuban exiles come to see the country as a land where there exist opportunities that merit reengagement. If Raul and his successors manage to instill confidence in those who must be the protagonists of a development project for the island, Cuba can still have a bright future. If they fall short, they will have paved the way for a road that leads to nowhere.

Washington, DC, USA

Eric Hershberg

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# Chapter 1

## Introduction

Claes Brundenius and Ricardo Torres Pérez

This book is a shared effort between Cuban and non-Cuban scholars to look at the problems, opportunities, and challenges that Cuba is facing now that it has undertaken the most ambitious plan for economic transformation since the Revolution over 50 years ago. The Cuban model as it was once conceived does not work in today's context, neither domestically nor internationally. Cuba is at a crossroads and something radical has to be done. Is an "updating of the model" sufficient? There is a saying that there "ain't such a thing as a free lunch." What will happen to the Cuban economy when there is "no more free lunch," in terms of special barter agreements with close allies?<sup>1</sup>

We hope that the discussion is objective, constructive and comprehensive in analyzing multiple spheres of the Cuban economy, with the added value of assessing this reality in light of other experiences, distant in many respects, but close in other ways, such as the Vietnamese *doi moi* (renovation) reforms.

In the first chapter Ricardo Torres gives an overview of the Cuban *problématique*. Modern economic growth involves structural transformation that must contribute to maximizing the use of resources available at baseline, as well as the progressive construction of new bases for accumulation. Even though the essential forces for this process are endogenous, the second half of the twentieth century has

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<sup>1</sup>In fact, "free lunch" has been an important ingredient in the daily lives of Cubans in the past. Practically all workplaces have supplied free lunch to its employees and workers. It has been estimated that the State has provided 3.5 million lunches a day at 24 700 workplaces all over Cuba (The Economist, 8 October 2009). These gratuities have since 2009 been gradually abolished and by now (summer 2013) hardly exist anywhere in Cuba. Instead workers are given a small allowance to purchase food themselves for lunch.

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demonstrated that an international insertion that serves development objectives is critical in an increasingly interdependent world. Judged in light of these exigencies, the evolution of Cuba's sectoral structure has clear deficiencies that have contributed to notably retarding the necessary process of achieving the best contemporary productive and technological standards.

The current theoretical and international context increasingly reinforces the original ideas of economic development that require implementation of an active strategically focused industrial policy. Nevertheless, given the challenges facing the island, lack of a coherent platform for addressing these problems is a striking omission. Presented here is a synthetic diagnosis with concrete proposals for guiding a new vision of structural transformation that allows for changing the pattern of external specialization, thus activating the enormous latent potential that the country possesses, in terms of natural as well as acquired advantages.

Within the macro- and meso-economic issues and specific areas of political economy that are discussed here, the analysis of the operational aspects of the Cuban economy is less common. This is one of the critical contributions of Oscar Fernández's chapter, which analyzes especially polemical and sensitive issues with a heavy dose of political economy, such as problems with the model for social management of the means of production, the economic organization of the Cuban state or the improvements needed in planning mechanisms, in moving toward a new model that considers contemporary economic trends, such as the specific particularities of socialist development in a country such as Cuba. In the following chapter Mauricio de Miranda discusses the problems of the Cuban economy and attempts to determine which economic reforms are the most urgent, with a view to dealing with the most difficult problems facing the Cuban economy, after a long and acute structural economic crisis which has seriously affected Cuban society.

While the *Economic and Social Policy Guidelines* (in this volume referred to as simply the *Guidelines* or *Lineamientos*) have initiated a new era of economic changes in Cuba, most experts agree that there is an area of particular importance given its nature as a base of support for launching the reorganization of the rest of the economy: the monetary, exchange, and financial order of the country. For some time the consensus has been that the system has developed into a situation that creates more problems than it was meant to solve. In light of the Vietnamese experience, expertly analyzed in the chapter by Pavel Vidal, it seems very clear that if any lesson can be learned it is indisputable that this area takes precedence over other policy priorities.

Generalized and sustained growth of economic efficiency will not be possible without a reworking of the general system of prices, especially a new equilibrium for the most important relative prices, to begin more accurately reflecting economic reality and to send reliable signals to economic agents, especially policymakers, so that decisions are in accordance with real conditions of production and demand. Another notable aspect of the Vietnamese experience is the importance of an efficient and well-regulated financial system for an economy in which resource allocation will take place necessarily and increasingly outside of the traditional mechanisms of central planning. Nevertheless, despite the relevance of this area,

there is no clear agenda, at least publically; the absence of such an agenda will be an impediment for rapidly advancing other aspects of the transformation.

There is consensus in Cuba that something must be done urgently about the current stagnation in agriculture. Agriculture is the area that initiated the transformations that today have become a full program for restructuring the bases of the economic model. Despite the urgency and general interest, the productive results have been modest in the best cases, and the general sentiment is that we are far from reaching the maturity and depth required for these transformations.

This issue is discussed in detail in the chapter by Anicia García and Armando Nova, which provides a timely overview of the key role of agriculture in development; Cuba's urgent need to move forward in constructing a viable model for the twenty-first century; and particularly, the inconsistencies among proposals in the Guidelines. Given this scenario, we should expect a continued debate over the problems and new waves of changes that will be more comprehensive and bold.

In October 2010 a series of measures were introduced by the Cuban Government as a means of stimulating self-employment activities (*cuentalpropismo*) in order to absorb large numbers of state sector workers. These new supportive measures were then ratified by the VI Congress of the Communist Party in April 2011, and further liberalizing steps were initiated in May 2011. This opening for small enterprises is perhaps the boldest shift in Cuban development strategy since the Revolutionary Offensive in 1968, when practically all small businesses were nationalized. This new *apertura* and its prospects are analyzed in detail by Archibald Ritter.

The role of small and medium sized enterprises (SMEs), innovations, and entrepreneurship in growth strategies is the theme in the chapter by Claes Brundenius and Le Dang Doanh, where the Cuban reforms are compared with the Vietnamese reforms since the initiation of the reform process (*doi moi*) in 1986. The chapter gives a detailed account of the current legislation on the non state sector in Vietnam, the discussions that led to the reforms and the results. The authors suggest that a non state sector in Cuba cannot be developed by self employment alone, and that a series of institutional reforms are necessary in order to foment a healthy, dynamic, and innovative SME sector in Cuba.

The chapter by Jorge Nuñez and Luís Félix Montalvo paper is a critical assessment of the Cuban science, technology and innovation policy (STIP) after 1995, and discusses in this context the new approach outlined in Chapter V of the *Guidelines*, "Science, Technology, Innovation and Environment Policy." There is a great need for establishing a new innovation system that sees innovation as an *interactive* phenomenon, affirming the interdependent nature (through network activities) rather than linearity in innovation processes.

One of Cuba's most critical problems is limited access to stable sources of foreign reserves. Since domestic sources are very scarce given low average productivity and other structural problems, this has led to persistently low rates of investment, directly undermining the economic growth rates necessary for a developing economy. Under these circumstances, official policy toward foreign investment has been especially unwise. Omar Pérez provides a comparative analysis of this issue with an assessment of the current Vietnamese experience, and proposes some elements that

should be considered in developing a framework that is more favorable to foreign investors.

There are at least two lessons that merit emphasis. First, a hospitable environment for foreign capital requires a gradual reduction in the discretionary nature of decision-making. This is a factor in Cuba that has notably affected confidence in the country. Additionally, the examples of Vietnam and China seem to indicate that foreign capital contribution to economic development depends on a national strategy that directs its use and types of operations. In both instances, the Cuban experience is frustrating, especially for a country with a strong Central Government.

Cuba has recently embarked on a search for comparative experiences that can inform the development of an “updated” Cuban economic model. The movement of Vietnam towards markets and that of the ALBA countries towards socialism suggest an interesting middle ground on which to base Cuba’s current domestic market liberalization within a socialist framework. This chapter argues that two additional sets of comparative experience merit careful consideration. One is the experience of broadly conceived *Social and Solidarity Economies* and of the *Socially Responsible Enterprises* that comprise them. The other is *Inclusive Market Development* policy frameworks that can foster rapid “pro-poor” sustainable development through productive activity. These additional sets of comparative experiences can provide road maps and resources for the rapid development of the non-state enterprise sector (NSE), a segment of which can be transformed into a SSE business enterprise system with simultaneous economic, social, and/or environmental objectives.

The volume concludes with four shorter reflections on the current reform process in Cuba, with references to future scenarios, by the editors plus two Cuban scholars, Juan Triana and Pedro Monreal.

# Chapter 2

## Structural Problems and Changes in Cuba's Economic Model

Ricardo Torres Pérez

### Introduction

In April 2011, the Sixth Congress of the Communist Party of Cuba adopted a document containing a number of guidelines for creating a path to gradually transform the Cuban economic model with the goal of greater long-term sustainability. Even with the current challenges, this change process can meaningfully contribute to addressing problems that go beyond immediate issues.

Indeed, there should be room for a longer-term vision that gives rise to a development strategy. This chapter discusses sectoral problems, an area that suffers from a number of inconsistencies and uncertainties, noting some of the earlier shortcomings and highlighting the opportunities available in this transformation process.

The chapter is divided into four main sections. The first section discusses the limitations of the structural transformation process over the last 20 years, while the second extends this analysis to the export sector. This is followed with an analysis of the principal approaches to sectoral policies contained in the Guidelines, emphasizing the limitations implicit in their perspective. The chapter concludes with some final reflections.

### Sectoral Dynamics and Related Problems

Long before the eruption of the economic crisis of the early 1990s, Cuba had begun to face acute problems stemming from its pattern of growth, which was characterized by inefficiency and external dependence for basic material and financial resources.

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The framework for integrating with the socialist community had a positive impact on several areas of Cuban society, but it also involved a high degree of technological dependence on standards that were far from cutting-edge. The loss of external resources derived from those relationships (Rodríguez 2010) triggered reinsertion into a complex international relations framework for which the economic system was not designed.

Following a very sharp contraction between 1990 and 1993, the average growth rate of Cuba's gross domestic product (GDP) over the past two decades has been around 1.8 % per year, ranking the country among the weakest performers in Latin America. If only the years after 1993 are taken into account, the average rises to 3.2 %.<sup>1</sup> This is still below the average for the region for that period, and is one of the poorest performances in the area.

Since 1994, the economy has managed to recover positive growth rates, albeit with high volatility. Some worrying trends have manifested in the productive structure, such as poor performance in goods-producing sectors, including poor export performance; high concentration of foreign sales in a few export items, usually with low value added; decline of several key branches of industry, for example the manufacture of capital goods; employment highly concentrated in services that are non-tradable and/or have weak linkages with other branches of the economy; and limited development of business services.

This has led to very slow growth in productivity, low accumulation rates and a systematic redistribution of resources from the few dynamic sectors to the rest of the economy and the social sector. This is an unsustainable trend that departs from economic theory and international experience, diverting the country away from a higher growth path. While the anti-crisis strategy facilitated restoration of some macroeconomic balances, it has been less effective in articulating a program of long-term structural transformation and growth. Thus, there are notable asymmetries at the sectoral level (Marquetti 1999; Sánchez-Egozcue and Triana 2010).

Following this trajectory, the center of gravity of the economy has continuously shifted towards services. With few exceptions, the most significant growth has been concentrated in this sector, while the performance of the goods-manufacturing sector is very heterogeneous, with an overall unfavorable balance.

Contrary to what might be expected based on development experience, the decline of population employed in agriculture has stagnated, and its labor productivity shows low levels and poor growth (Table 2.1). This indicates the sector's exhaustion as an engine of structural transformation (Gollin et al. 2002) with regard to the creation of tradable goods and as a source of capital accumulation, reallocation of the labor force to other sectors of the economy, a source of domestic demand for manufactured goods, and a supplier of raw materials for industry.

Additionally, there has been a negative association between productivity growth and the rate of price increases (Fagerberg 2000). This would partly explain the price behavior of agricultural products in Cuba and their high levels, although other

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<sup>1</sup> Calculations based on CEPALSTAT (2012).

**Table 2.1** Selected indicators for agriculture, Cuba

	1991	2003	2010
Productivity (Cuba = 1)	0.34	0.23	0.16
Share of total employment (%)	22.1	25.4	18.5

*Source:* Author's calculations based on the Statistical Yearbook for Cuba ([several years](#))

relevant factors, such as production costs and market structure, also influence these patterns. In practice this results in a high proportion of food products in the consumer goods basket of Cuban families (Anaya and García 2006). Additionally, agricultural stagnation has a negative impact on spatial equity, excluding progress from rural and mountainous areas, as well as from many localities throughout the country. Historically poorer regions, like the Eastern part of the country, also have been adversely affected (Íñiguez 2010). Finally, in demographic terms, considering that medium-term growth of the labor force is at significant risk, there needs to be a shift toward greater labor productivity, and as part of this effort, closing the gap among sectors farthest from the economy's median plays a key role. This is especially relevant for Cuba since the agricultural sector employs one-fifth of the workforce.

A separate analysis of industry is especially important due to the strategic value it has for a developing economy. Historically, countries that have achieved the highest levels of progress have depended on the expansion of a solid and diversified industrial base. Manufacturing produces capital goods needed for investment, leads to major technological breakthroughs and the highest productivity growth, and generates the strongest linkages with other activities. Developing countries still focus a substantial part of their economic development efforts on the creation of a powerful industrial base that can substantially contribute to transforming other areas of economic life.

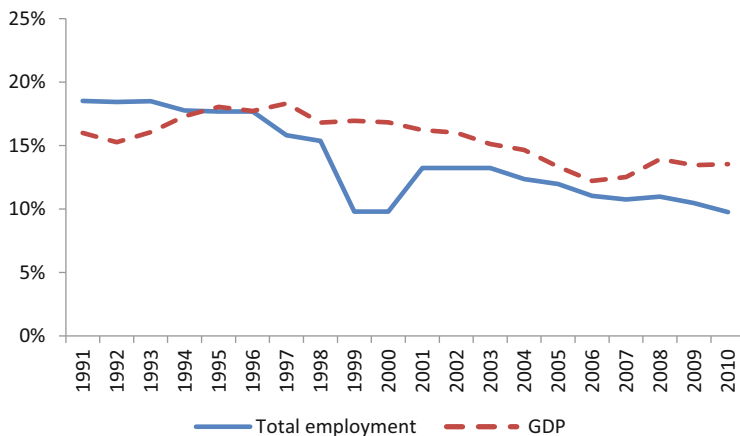
Cuban industry was hard hit by the economic crisis. This was due to its high dependence on imported inputs, lack of short-term access to other markets and steep downsizing in the sector. However, from 1994 to 2001, growth in industry exceeded that of the rest of the economy, so the sector contributed positively to overall growth. Over the medium-term, growth in the industrial sector was sustained by increased access to frontier markets generated by tourism development, sales in hard-currency stores and the robust performance of nickel production. But without new stimuli, this dynamic began to vanish by the end of the decade.

Since 2002 there has been a persistent decoupling between the agricultural and industrial sectors, and this gap is tending to widen.<sup>2</sup> This is due to several negative factors that have combined over this period and have defined a sui

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<sup>2</sup>It should be recalled that the type of trajectory is important to understand the effects of this outcome. Relative decline of industry's share of GDP is a well-described trend in developed economies. The term "deindustrialization" has even been coined to name this process. However, comparisons with what is happening in some developing countries may lead to confusion. The decreasing role played by industry in several developing countries mostly reflects a stagnation of productivity and even a decline in total production, while this is not the case in rich countries.





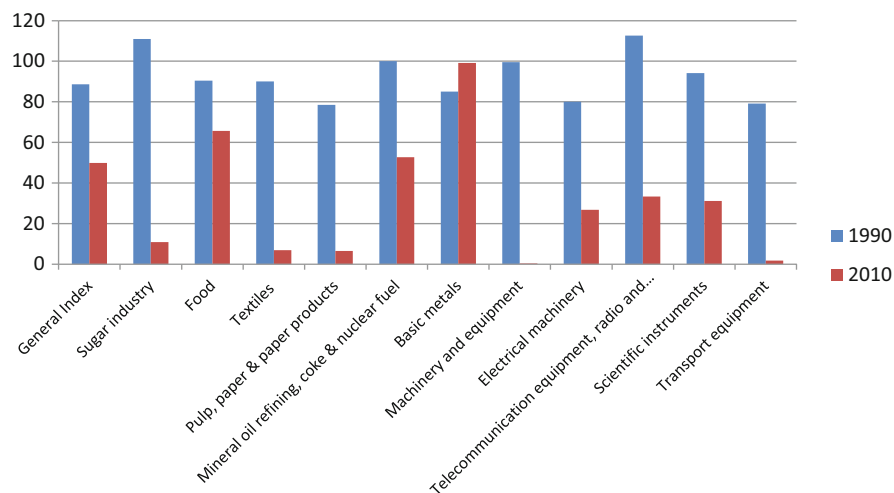
**Fig. 2.1** Share of manufacturing in GDP and Employment, 1991–2010 (%). *Source:* Cuba’s statistical yearbook ([several years](#))

generis growth style. First, restructuring in the sugar industry resulted in that sector’s decreased economic contribution, which had represented a significant share of the manufacturing output value. The measure negatively affected sectors directly linked to the sugar industry, such as mechanical production and segments of the textile and chemical industries. Finally, processing industries like the food industry that depend on raw materials and by-products from the sugar industry were also affected.

The second element is this decade’s stagnation in tourism. The attacks on the Twin Towers in the United States, the maturity of the tourism industry and centralization (beginning in 2003) that resulted in restrictions on the business system worked against this sector’s performance, which had exhibited double-digit growth rates in arrivals until the beginning of the decade. Slower growth in tourism reduces the multiplier effect for the rest of the economy, particularly in industrial production. As a result, the share of manufacturing in GDP and employment has contracted persistently over the past two decades (Fig. 2.1), which indicates a process of systematic loss of engineering capabilities that threatens the nation’s prospective technical development.

This trend can be seen more clearly in the industrial output of selected branches, which reflects a deep contraction in most industries, with a few exceptions (Fig. 2.2). This decline is sharper in areas that are critical to economic development, such as manufacturing of machinery and equipment, and the chemical and sugar industries. Industries closely linked to Information and Communications Technology (ICT) also did not perform well. Thus, it can be said that the technological profile of Cuban industry has suffered a setback due to the failure to develop industries that require a high level of knowledge or technology. The only exception is pharmaceuticals and biotechnology, which have had above average results.

The situation is similar for employment. A significant proportion of job losses in this period were in manufacturing, and its share of employment is declining continuously.



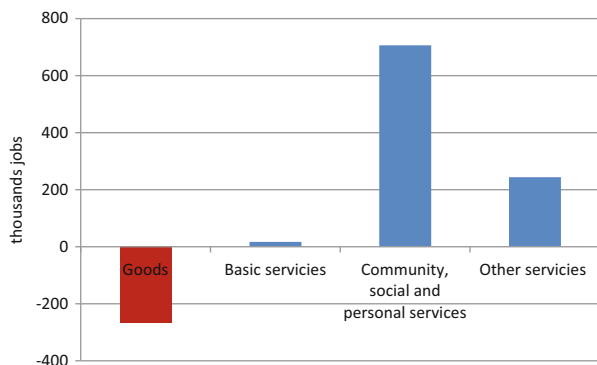
**Fig. 2.2** Industrial output index in selected branches, Cuba (1989=100). *Source:* Cuba's statistical yearbook ([several years](#))

Historically, manufacturing jobs are associated with a positive qualitative effect. The skills and expertise necessary for the design, manufacture and maintenance of machinery and equipment are the best school for training the labor force required for the economy as a whole. This is due to the diversity and complexity inherent to most manufacturing activities, which are an important source of learning for managerial as well as technical and engineering skills. For this function, the results of the export sector, especially shipments of goods, weigh heavily.

These trends in manufacturing are mirrored by a growing role for services in job creation, in total value added, and especially in exports. In the 1980s services already made up the largest proportion of GDP and employment,<sup>3</sup> but their role continued to increase subsequently. This sector's absorptive capacity has been considerable, accounting for over 80 % of all jobs created in that period (Fig. 2.3).

This evolution is driven by an economic policy that has prioritized the preservation of low unemployment rates, even when new jobs are not fully justified by production needs. Thus, it is not coincidental that the largest numbers of workers have shifted towards services, especially social services, where employment cost is much less in terms of physical capital, and the skills and expertise are acquired more quickly. Figure 2.3 shows the contrast between most job losses, which are linked to material production, while in all service sectors the rate of job creation has been positive, particularly in social services. As noted previously, as a trend this pattern seems unsustainable in the future.

<sup>3</sup>Historically, the proportion of employees in the tertiary sector has been high in Cuba, for various reasons (Torres 2011:56).



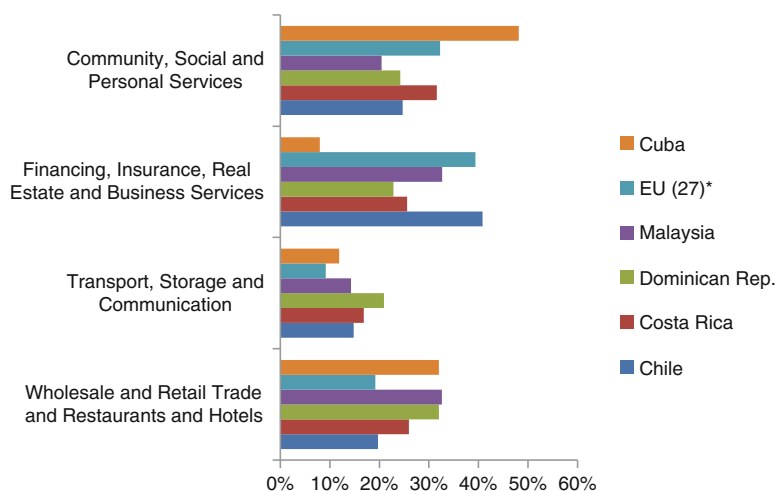
**Fig. 2.3** Employment creation in selected sectors of the Cuban economy (1991–2010). *Source:* Cuba's statistical yearbook ([several years](#))

However, the structure of this sector reflects essential weaknesses that limit the country's long-range growth. These weaknesses are rooted in critical factors such as the need to create an abundance of quality jobs that are economically sustainable; the strengthening of domestic integration by establishing linkages with other industries; and technological development and its contribution to easing external restrictions over the long term, which is a key element in the Cuban case.

The sector itself is very diverse. There are activities directly related to production, such as finance, distribution of goods and advertising; while others only have an indirect link, such as education and health care. But they linkages may also be very thin, almost imperceptible, such as caring for the elderly and other social services (community centers, sports centers, etc.). Funding for these services must always and necessarily come from income transfers from the productive sector. Developing service sectors in such a way that they can absorb the entire labor force not employed in the production of goods entails a corresponding transfer of income from productive activities to the service sectors. This occurs automatically for activities that are part of the value chain in the form of purchase and sale of these services, such as the financial sector, trade and communications. Additional financing is provided through taxation or other funding sources, particularly for public services, such as education, health care and civilian security, and sports and culture, among others.

Figure 2.4 shows that compared with other countries or groups of countries where services account for the largest portion of the economy, Cuba has a disproportionately large share of added value generated in a set of activities that rely almost exclusively on transfers from other activities.

Additionally, these activities do not provide direct linkages with principal production chains, nor does it generate technology capable of having a substantial influence on other sectors. It could be said that this imbalance is largely due to the choices made by decision-makers, rather than a coherent logic in the country's development. Moreover, the human capital generated as a result of these social



**Fig. 2.4** Structure of the tertiary sector (selected countries and regions, 2011). *Source:* Own calculations based on CEPALstat (2012), Panorama Económico y Social (2012), and Eurostat (2012). *Asterisk* corresponds to 2010

priorities does not have the capacity to subsequently be applied to production of goods and services.

In Cuba, funding of social services and a large portion of community services is borne by the State, through the Budget. The success of this structural arrangement requires a steady increase in production and productivity in the rest of the economy, so that the transfer of resources does not compromise long-term economic expansion by diverting resources needed to finance necessary investments in productive activities and physical infrastructure. On the other hand, services that play a crucial role in the operations of other sectors, such as productive services, are much less influential, which reflects the country's particular industrial structure and the low levels of specialization within the business system.

## Export Sector Evolution

After the loss of the socialist-country markets, Cuban foreign trade suffered a hard and long process of adjustment to the new conditions of international trade. High dependence on imported inputs meant that given rapid deterioration in the terms of trade, material production was seriously affected. This had an immediate impact on goods exports, which fell dramatically both in terms of volume and value following the sharp decline in trade with countries from the socialist block.

Table 2.2 shows that generally, and particularly for exports of goods, the country's direction has not been satisfactory. While some studies observe a positive effect of exports on growth, the contribution is far from what it could be given international market conditions. In practice, income derived from the favorable terms of

**Table 2.2** Exports<sup>a</sup> of goods and commercial services, Cuba (1990–2011)

	1990	2011	AGR <sup>b</sup> 1990–2011 (%)
Total	5,435	18,329	6.0 (8.2) <sup>c</sup>
Goods	4,910	6,300	1.2 (8.2) <sup>c</sup>
Services	525.4	12,029	16.1 (8.1) <sup>c</sup>

Source: UNCTAD stat (2012) and author's calculations

<sup>a</sup>In millions of current USD

<sup>b</sup>Average annual growth rate

<sup>c</sup>World average

trade with the socialist community has not been replaced by another source, which reflects low capacity to adapt to international markets.

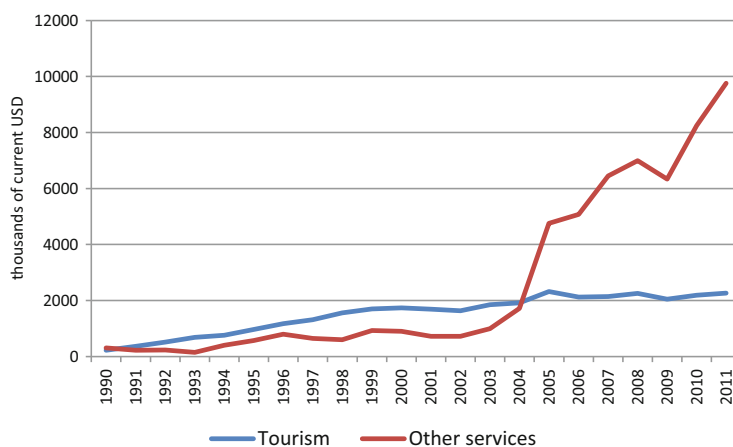
Moreover, the export technology profile has not changed substantially in the last two decades, which is an ongoing contradiction given the country's supply of skilled human resources. In 2010, about 80 %<sup>4</sup> of the sales of goods still came from commodities, mainly nickel, which has become the country's main export item. This profile largely reflects the evolution of the industrial sector, in which a distinctive feature of the best performing branches is their dependence on the exploitation and processing of natural resources for foreign markets, with the exception of the medical-pharmaceutical sector.

As mentioned, sales of services have been the most dynamic component of Cuban exports in the last 20 years. In the 1990s, tourism was the best performing sector, both in volume and growth rate (Fig. 2.5). In addition, several studies (Quintana et al. 2004) found services linkages created with other sectors, thus making a positive contribution in terms of the current account balance as well as to the revival of other activities.

In contrast, tourism growth stagnated in the first decade of the new century, while the Bolivarian Alliance for the Americas (ALBA)<sup>5</sup> opened new markets for the sale of professional services, especially health care and education. Additional opportunities have recently emerged with Algeria, China, Angola, Qatar and South Africa. Agreements for providing health care services have been signed with all these countries, including in some cases for building and operating various specialized hospitals, especially ophthalmology. Additionally, there has been some progress in education, particularly with Spanish language teaching (China and South Africa). In some instances (Qatar, Angola), services exports have expanded to include sports, due to Cuba's expertise and achievements in international events.

<sup>4</sup>UNCTADstat (2012).

<sup>5</sup>ALBA was founded in December 2004, with the signing of initial documents by Venezuela and Cuba. It was conceived as a mechanism for integration within the Latin American and Caribbean region that promotes trade and investment-related as well as other important issues on these countries' agenda, such as education, health care, sports, science, international relations, among others. It is based on economic and social complementarity rather than competition among sectors and products through competitive advantages. Over the last few years, Bolivia, Nicaragua, Ecuador and three small Caribbean island states have become full ALBA members.



**Fig. 2.5** Exports of main service categories, Cuba (1990–2011). *Source:* UNCTADstat (2012) and Panorama Económico y Social (2012)

However, the high concentration of sales to Venezuela and the terms of the agreements reflect the limitations of this development. According to the Minister of Foreign Trade and Foreign Investment (Malmierca 2010), almost 91 % of Cuban collaborators abroad were working in Latin America (mainly Venezuela) in late 2009. As a proportion of income, the level of dependence on a single market is very high—a major vulnerability for these transactions. Moreover, these agreements rest on commitments forged on the basis of political alignments, with generous terms on both sides. The sustainability of these types of deals clearly depends on the continuity of the Venezuelan political process.

Other factors to be considered include projected demand in major markets, the potential for job creation and linkages to the Cuban productive apparatus. In the case of the ALBA countries, these programs involve a significant investment in training local doctors and other specialists to build the skilled human resource base. Beneficiaries of this training will eventually take the place of Cuban doctors, meaning increased demand for these services is unlikely.

Moreover, according to the Minister (Malmierca 2010), the total of Cuban professionals abroad reached 49,119 experts, most of them in the medical field. This accounts for less than 1 % of the total workforce in Cuba in 2009, which numbered just over five million workers. This policy leads to high productivity, greater utilization of skilled workers and substantial income generation that relieves external constraints. However, its potential as a direct engine of structural change is low due to the insufficient creation of high productivity jobs.

This situation is compounded by the fact that, so far, linkages with other sectors are rare given the prevailing business model, which is based on the export of professionals. With the exception of the manufacture of a specific group of medicines and equipment, Cuban industry is unable to supply the equipment required for a

modern hospital or clinic, since it is highly decapitalized with limited technological development. Thus, these needs are met through imports from third countries. This is an avenue that could be explored in the coming years, but it would require considerable technical development, which would entail significant investments and highly skilled human resources.

## **The Proposal for Transforming the Cuban Economic Model: A Sectoral Focus**

Current changes in the Cuban economic model must contend with a number of disequilibria that had been prioritized in economic policy-making up until 2011.

As a result, short- and medium-term issues have been given a greater weight in current planning, to the detriment of longer-range considerations. Clearly, there's a lack of integration to approaches for addressing structural weaknesses that ultimately cause most circumstantial economic failures, especially recurrent external imbalances and difficulties in sustainably creating high quality jobs.

Furthermore, the *updating of the economic model* takes place within a more heterogeneous and plural scenario with regard to the relevant economic actors. Thus, a major challenge for economic policy will be integrating these actors in a way that contributes positively to overall growth, while avoiding the proliferation of missing links and isolated compartmentalization. This will require a great deal of institutional innovation and flexibility, since the current economic system has been based on a set of rules and mechanisms with a high degree of rigidity and inertia in the face of change.

Before engaging in an in-depth analysis of the structural change policies in the Guidelines, it should be noted that this document would not in any case provide a comprehensive and thorough program of selective sectoral policies, since the spirit of its letter and its role in the current context go far beyond the purely technical realm, which is always narrow in such cases. However, that in no way justifies an ambiguous and segmented approach, which later on would result in the type of program described above. It is in that spirit, and with a detailed analysis of the need, usefulness and urgency of the above-mentioned program, that this analysis is put forward. Perhaps the most significant contribution might be to provide a series of arguments that address specific limitations within the prevailing vision of the root causes of many of our problems, and offer a way to consider a coherent policy to begin overcoming these distortions.

Generally, problems in the country's productive structure are addressed in a very general, vague, scattered and isolated fashion. The implicit conception of industrial policy itself is limited, because it is identified as manufacturing (Chapter VIII), although there are hints in other chapters (Chapter I, II, III, IV, V, VII, IX, and X). As shown in Table 2.3, sectoral policies are vague and indicative, and administrative instruments are predominant, in accordance with the prevailing view of the role played by the National Economic Plan.

**Table 2.3** Sectoral policies in the Guidelines for Economic and Social Policy

Section	General objective	Intersectoral reference	Specific sectors
Diagnostics	Reducing the external debt	Exports and import substitution	Agriculture
Chapter I	Eliminating subsidies for enterprise losses	Unprofitable companies	–
Chapter II			
Monetary policy	Supporting the development of certain activities (credits)	Exports and import substitution; other activities that may guarantee economic and social development	–
Fiscal policy	Supporting the development of certain activities (implicit in the document)	Key sectors, export funds, import substitution, local development, environmental protection	Agriculture
Chapter III	Diversifying exports, higher value-added and technological content	Exports and import substitution	Parts and spare parts (mechanical industry), industrial sector, special development zones
Chapter IV	Prioritizing investments in selected branches (implicit)	Productive area, services that generate benefits on the short term, infrastructure	–
Chapter V		High value-added exports, import substitution	Biotechnology, medical and pharmaceutical, software, renewable energy, high-tech equipment, high value-added scientific-technical services, nanotechnology
Chapter VII	Improving the contribution to the balance of payments	Food import substitution	Cattle raising, rice, beans, corn and soy beans, coffee, honey, cocoa, cigars, citrus fruits, fruits, sugar, platform fishing, aquaculture
Chapter VIII	Export promotion, cost reduction	Exports (implicit)	Pharmaceuticals and biotechnology, nickel, gold, silver, chrome, copper, and zinc, electronics industry and Information and Communication Technologies (ICT), Cienfuegos industrial park, fertilizers, tires, packaging, construction materials, steel, recycling, mechanics, oil and natural gas, renewable energies

(continued)



**Table 2.3** (continued)

Section	General objective	Intersectoral reference	Specific sectors
Chapter IX	Maximizing direct foreign currency earnings		Health tourism, yacht clubs, golf, real estate companies, adventure/nature tourism, conferences, culture
Chapter X	Strengthening the transport chain (implicit)	–	Shipyards

*Source:* Compiled by the author based on the Guidelines of the Economic and Social Policy of the Party and the Revolution

So far, this plan is limited to successfully balancing supply and demand, following the priorities established out of the urgent need to increase revenues in hard currency and improve the country's balance of payments. This constrains flexibility to respond to an evolving environment, leaving enterprises in a compromised position to fulfill their social mission.

This contradiction seems to be irreconcilable with embarking on a sustainable path for economic development. History has shown it is a highly inefficient mechanism and promotes exactly the kind of negative incentives that are undesirable for a prosperous society. Indeed, transformation of the productive structure takes place over the long term and does not respond to the resolution of temporary imbalances, which are ultimately more a symptom than the phenomenon itself.

In the document, the sectoral priorities correspond to the main problem identified at the macroeconomic level: the *external imbalance*. The entire document is permeated with the urgency of addressing this issue, and this policy area is no exception. The introduction itself suggests this bias, since it identifies the causes of these disequilibria with:

- Exogenous factors.
  - International economic crisis.
  - United States blockade.
  - Natural disasters.
- Endogenous factors, mainly operational problems, which worsened starting in 2005, such as excessive centralization of foreign exchange management.

This analysis does not explicitly consider problems in the country's productive structure that essentially explain the external imbalance as well as the amplified effects of exogenous events such as the international crisis and the US. blockade. The main difficulties identified are decapitalization of the productive base and infrastructure deterioration, while priorities are ambiguously set, with emphasis on agriculture, exports and import substitution. This essentially short-term approach cannot be viewed as a development program, since it overlooks several key aspects of this process, such as gradual upgrading in the complexity of economic activities, the attenuation of productive heterogeneity and the reduction of gaps in inter-firm networks.

With respect to the broader strategic objectives of export promotion and import substitution, the most important long-term task Cuba faces is to become a successful exporter, without disregarding the domestic market and opportunities for increasing import substitution. However, the relative size of the country, current level of economic development, natural resource endowments, the global organization of major production chains and the dynamism of scientific and technological progress indicate that, in any case, a marked reduction of the import coefficient seems unlikely and is beyond the reach of our policies. However, the incentives and objective conditions necessary to augment the nation's export volume are in fact endogenous to the economic model. In the long run, it does not matter how high the import coefficient rises if the same indicator for exports is higher.

However, government-planned export promotion is risky. The probability of choosing losers is high, since the information available to decision makers is always very limited. This is even more relevant in Cuba, in that the level of relative price distortion is very high as a result of the coexistence of many partially overlapping markets operating with different monetary units and multiple currency exchange schemes. Thus, instead of targeting specific sectors within a limited set of choices, it is preferable to begin with a set of horizontal measures that improve the quality of the regulatory framework, transforming the incentive structure for producers. Stronger inter-firm links will not be achieved by issuing a decree; rather, they must emerge from the survival and development strategies of the enterprises themselves, regardless of the type of ownership. That is why the transformation of mechanisms that restrict enterprise autonomy is critical; not even the most qualified bureaucrat can interpret the relevant signals in a market as accurately as those who are constantly operating in it.

There are two principal types of economic activity that are susceptible to export promotion. First, there are several sectors that enjoy a comparative advantage due to the abundance of a particular natural resource, many of which are traditional sectors. It may seem that the important factor is the income associated with the exploitation and eventual export of the resource, without taking into account other relevant dimensions such as the extent of the value chain, the creation of better and more productive jobs, the establishment and development of backward and forward linkages, among others; not to mention the effect on nearby communities or regions. Viewing all these elements as a whole, it seems clear that perhaps what is important is not the associated income, but the long-term *multiplier* effect, including the endogenous development of new productive capacities, especially the accumulation of knowledge in the productive structure.

Value added is not limited to medium- and high-technology manufacturing; it can also be created in primary industries, natural resource-based or low-tech manufactured goods through diversification, linkages, design, and branding strategies, among others. Value added to products through innovation is more relevant than pure economic rent derived from the exploitation of natural resources. In effect, the fastest growing economies continue to exploit their natural resources, but they do so by maximizing their contribution from increased value added.

In the case of the extraction and exploitation of natural resources, *process industries*, in which raw materials are directly processed through chemical, electrical, heat, or other methods (such as steel, paper, tomato sauce, gasoline, plastics), the principal distinguishing feature is that the production process takes place “within” the equipment system and the staff oversees and supports the process instead of carrying it out (Pérez 2010). Process industries require a particular form of innovation management that focuses on the design and eventual manufacture of the equipment and/or the development of more efficient processes (such as less energy consumption, time saving). The engineering capacities necessary cannot be developed in the short term and have remained elusive for most poor countries. This explains the continued dependence on foreign suppliers and value chain positions limited to the most primary processes, with more complex links oriented towards manufacturing of final goods left to developed countries. In the case of Cuba, this trend is evident in the nickel and sugarcane industries.

The other area susceptible to export promotion includes sectors based more on skilled labor, such as biotechnology, medical-pharmaceutical manufacturing, the software industry, advanced technology equipment, nanotechnology, and scientific and technological services with high value added. However, there is not much clarity about the role the State can play in promoting these exports. For example, is the model of the Western Scientific Park in Havana replicable in all cases? What are the key factors for success in progress along this path?

In any scenario, a highly qualified labor force<sup>6</sup> is an essential element of this sub-sector. Additionally, gaps in the relevant infrastructure, such as Information and Communications Technology (ICT), should be fixed. Finally, it seems there are two different economies, each with its own framework. In today’s world, technical progress is not limited to a few *high-tech* sectors; rather, development is increasingly cross-cutting or horizontal in nature. Information and Communications Technologies are already a classic example. Their economic impact is not measured by size based on technological and economic criteria, such as number of employees or participation in the value-added structure, but rather by the ability of other branches of the economy to integrate them to foster productivity growth, personalize goods and services or conquer new markets.

In general, the Guidelines do not explicitly address industrial organization, except for a change in the traditional attitude toward unprofitable entities. This would suggest that doors are being opened for the restructuring of some sectors that have experienced a steady decline, such as light industry and possibly other branches.

In other development experiences, the way optimal industrial structure has been addressed has been key, though less publicized. The essential idea is to find an effective organization in terms of the number of firms operating in a sector, their average size, and the type of relationships established among them, so as to ensure an adequate level of competition without squandering scarce resources. At the same time, each country has developed its own approach for creating a base of small- and

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<sup>6</sup>See Cribeiro (2011).

medium-sized enterprises that operate in sectors with limited average production scale, or that make up the bulk of the subcontractors for larger companies. The latter model has been paradigmatic in Japan and South Korea, while in Taiwan this type of entity has dominated the most successful sectors.

So far, in Cuba, the development plans for several promising sectors do not explicitly include the participation of domestic small private producers, whether for the provision of services or the production of specific goods. It would be advisable to reconsider this view, given that the Guidelines recognize the participation of different forms of ownership in the economy as well as the possibility of establishing business relations among them. Although this has been endorsed by the current law, the fact that the range of activities for the non-state sector is very restricted prevents successfully achieving these goals in practice. This is a clear contradiction with respect to the educational profile of the Cuban labor force.

Thus, stimulus for the development of a network of firms that supports the growth of large state-owned enterprises would not undermine the principle that the basic means of production remain in state hands, assuming that key links in the value chain where such businesses would be located are properly identified. This adds a new and positive element, in that the domestic market will play a greater role in the development strategy of some sectors, particularly the industrial sector, as the non-state sector is considered a necessary investment target along with tourism and the efficient replacement of some imports.

## Final Reflections

The country's productive structure is suffering from numerous problems that require a change in perspective. First, it is unable to create enough jobs in high productivity sectors, thus slowing the growth of aggregate productivity. The proportion of employment in social and government services exceeds the international standard by far. Linkages between this sector and the productive fabric are weak, and maintaining it requires the systematic transfer of resources from other activities. Other services that have a positive impact on productive activity play a minor role in Cuba, thus contributing to a vicious circle of low productivity, low competitiveness and resource scarcity.

Export sectors have been unable to address this problem due to the high concentration of export earnings in very few branches that do not create many jobs, such as nickel or health services. Although tourism can be considered an exception, its contribution (Quintana et al. 2004) is not enough to compensate for the lack of dynamism in other sources. Nor do the fastest growing sectors enable the proper utilization of human resources in the country, in some cases due to their technological profile (primary commodity exports), in others, due to small size (biotechnology or professional services).

Job creation will require a particularly significant effort from the government, in some cases through increasing the volume and profile of investments,<sup>7</sup> in others, by facilitating accumulation in the non-state sector and improving the regulatory framework. Although small private businesses and cooperatives taking off can be part of the solution, it will not be the only factor. Aggregate productivity can benefit from this shift in the labor market only if new jobs created in these areas have higher productivity than those lost in other areas. As part of this effort, encouraging the expansion of a new set of more complex activities is urgently needed. The activities approved so far for self-employment are not consistent with the educational level of the labor force, nor will they generate many high-productivity jobs with higher pay within this framework.

The country needs new engines for growth that combine the creation of high quality jobs with high export revenues, denser linkages with the rest of the economy and better use of the relatively high skill levels of the labor force. Diversifying the productive effort is important; there are opportunities at the local or regional level that although not large-scale, would allow for the development of highly specialized niches.

At the national level, the integration of domestic industry into the major investment projects that are underway or are planned for the coming years should be considered. The volume of resources committed could revive many plants; and even though they would be capturing just a small percentage of the demand, this would open new opportunities for those industries. The strategic nature of the Cuban energy sector is not only due to potential high revenues from the exploitation of new oil fields; it also presents a unique opportunity to align the growth strategy in key industries such as capital goods to support investments in new projects. This makes more sense in view of the country's metallurgical base. Its weakness lies in the cost of energy, but if a significant increase in domestic production is finally achieved, it could make a positive contribution.

The potential contribution of an ongoing revival of the agro-industrial complex cannot be underestimated, particularly in sugar cane. Low yields and the current percentage of idle lands provide a huge opportunity for productive job creation as well as increased production, along with possible linkages to other areas of the economy.

Additionally, immediate action should be taken to ease the burden of bureaucratic restrictions that prevent the potential of the productive forces from fully developing in the midst of these difficult conditions. The goal is to create a better scenario for directing the country toward policies that achieve structural transformations leading to qualitative change in the development of the Cuban economy. Based on the above analysis the following conclusions can be drawn:

1. The current framework for transformation has limitations in concept, method and approach for the establishment of a coherent and integrated program of selective sectoral policies.
2. There are real possibilities to implement a new approach that generates policies with a more systemic and strategic vision.

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<sup>7</sup>The rate of capital accumulation has been fluctuating between 10 and 15 % ([Statistical Yearbook for Cuba](#)). This is far from the needs of a high-growth economy.

There are current initiatives that might facilitate the proposals made above. These include the restructuring of the State apparatus, which will reduce bureaucracy and make State management much more efficient, and hopefully, less likely to interfere with the operation of enterprises. The degree of freedom permitted to State firms is critical, since most productive assets will continue to be concentrated in the State sector.

The implementation and scope of promotion policies at the sectoral level are the primary source of conceptual and methodological limitations. As discussed, the very concept of branch has fallen into disuse, as the range of products, technologies and companies has widened considerably. Currently the top priority is a more holistic approach, which has led to the inclusion of nonindustrial sectors in such policies, with the goal of creating inter-sectoral synergies in the economy, so that the real competitive advantages of a nation can be exploited, where they exist. This becomes more important if an increasing degree of internationalization of economic activities is added, as a result of which complete vertical cycles are much more difficult to achieve, and less efficient in practice.

The third type of limitation relates to the approach being adopted. Even if the current strangulation factor is the country's external finances, the ultimate goal in the development of any activity should not be maximizing the country's external revenues. This trend is a result of the very structure of the external sector itself. First, the low export capacity of a small and underdeveloped country; secondly, the structure of these sales in several respects (Torres 2011); and finally, the low level of domestic integration; something that will gain more importance as producers diversify according to size and type of ownership (Díaz and Torres 2011).

Indeed, other factors must be taken into account, including the incorporation of new technologies, the generation of internal productive linkages, the creation of jobs with high productivity, the possibility of securing a portion of inputs from nearby communities or regions, among others. However, evidence shows that in Latin America, in the early stages, where there are changing institutions, it is best to begin along this path with cross-cutting and more *neutral* actions that foster economic agents' adaptation and create more favorable baseline conditions for advancing to a stage in which more complex instruments are combined, targeting specific sectors and industries. This would also allow policymakers themselves to undergo a gradual learning process, allowing them to be better able to fulfill their purpose.

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# Chapter 3

## The Economic Transformation Process in Cuba After 2011

Oscar Fernández Estrada

At the National Popular Assembly on August 1, 2009, for the first time Cuba's President, Raul Castro, explicitly referred to the need to transform the economic foundations of the Cuban socialist project. He issued a call to define "with the broadest popular participation, the socialist society we aspire to and that we can build under the current and future conditions of Cuba, the economic model that will govern the life of the nation (...)" (Castro 2009).

From that moment on, with the convening of the sixth Congress of the Communist Party of Cuba (the first Congress to be held in 13 years), the economy became the central topic of discussion on the streets of the Island. As part of this process the Party leadership sponsored a debate that involved large sectors of the population in public consultation over a set of new concepts and general measures that would govern the country's economic life in the future.

Nevertheless, an explicit goal of these debates was to isolate "economic issues" from the remaining fabric of social relations, postponing discussion of "political issues." Although this approach meets the need in current Cuban political practice to consolidate a standard for (economic) rationality, which had been subordinated or nonexistent, it also precludes a more rigorous investigation into reality, and risks imposing a bias of economic pragmatism. Moreover, the principal lesson from Eastern European reform processes is the importance of maintaining political control over the dynamics of economic change to prevent reactionary forces from accessing the power base.

The Congress resulted in the definition of over 300 proposals covering broad areas of economic policy that are contained in the document "Guidelines of Economic and Social Policy of the Party and the Revolution."

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The guidelines established a multifaceted approach to economic reform (the “update of the model” as it is officially called<sup>1</sup>). Their purpose is to revitalize and develop the economic foundation of the socialist project, and they address a wide range of issues, including economic management formulas, macroeconomic policies, foreign policy, investment, science and technology, social policy, agriculture, industry, energy, tourism, transportation, construction, and trade. However, the most substantive changes, with important implications for the traditional way of conceiving the socialist economy in Cuba, are taking place within what this paper defines as the “economic functioning model.”

The following is a discussion of the most relevant aspects of the functioning of the Cuban economy, as well as an analysis of how the promoted changes contribute to development within a socialist paradigm.

## Core Concepts in the Functioning of the Economy

Economic policy in contemporary Cuba is facing myriad and diverse challenges, and complex analysis is required for understanding how the country’s recent profound changes engage these challenges.

First, we observe<sup>2</sup> that economic policy takes place at three very distinct levels: Short term macroeconomic equilibriums; capacity to address persistent problems at the economic structure; and the more general principles of the functioning of the economy as a whole, understood as the economic functioning model.

Economic functioning of an economy can be analyzed in terms of the configuration of a set of at least six interdependent variables with different nuances depending on the model. These are: (1) Relative weight of the various forms of ownership; (2) Management models for state ownership; (3) State economic organization; (4) Characteristics and structure of aggregate markets; (5) Predominant mechanisms for regulating production; and (6) Relative weight of the various sources for wealth distribution. Building a specific economic functioning model requires choosing particular principles for each of these variables; the theories followed must be aligned with the context and the type of socio-economic project that is sought. Therefore, for the Cuban model it is critical to rigorously clarify systemic limits within each variable to avoid a potentially irreversible transition process that may endanger the socialist paradigm that majority of cubans are trying to strengthen with the ongoing reform.

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<sup>1</sup>Cuban authorities have decided to avoid the term *reform* due to its association with the neoliberal approach enshrined in the Washington Consensus adopted internationally over the last few decades. However, the main objectives and features of those reforms are diametrically opposed to the Cuban approach. Several countries that have sought to reform their model within a socialist paradigm have applied their own qualifiers. For example, during the Chinese transformations after 1978 reference was made to *modernization*; the Vietnamese reform in the late 1980s was called *renovation*; changes in the USSR in 1985 were initiated under the term *reconstruction*, while the leadership of the Communist Party of Cuba has labeled it an *update*.

<sup>2</sup>Following the reasoning proposed by Jan Tinbergen (Tinbergen 1959).

Below is a brief summary of the essential features of the current model of the Cuban system, its main limitations and most significant challenges, based on an analysis of the six core concepts listed above.

### ***Relative Weight of Various Forms of Ownership***

Undoubtedly, the new model advocates an increase in ownership regimes that are less socialized, but assets that are currently State-owned will not be privatized, as per established norms. Beginning in the early 1960s, the state sector's role in the economy kept expanding until it reached its peak in 1989, when it employed about 95 % of the total workforce. As a result of the 1990s reforms, there was a slight decline in the omnipresent role played by the state sector as employer; by 2009 it engaged about 84 % of the total number of employees (ONE 2011).

Moreover, the domestic private sector was already gaining in importance, even beyond what can be captured by the National Statistical System. For example, in 2009, according to figures from the National Statistics Office, more than one million people of working age were not employed (not as State workers, self-employed workers, members of a cooperative, or as independent farmers), were not looking for work and were not enrolled in higher education. Presumably, a considerable number of these million people were informally employed in the private sector, either as individual workers, salaried workers or small business owners.

Thus, the new policy's expansion of private employment is merely an accurate diagnosis of the real circumstances during this particular period of Cuba's development within socialism. The principal merit of the new model's reformulation of ownership is the harmonization of existing regulations with the real conditions of the reproduction of society.

Moreover, with its expansion in the 1990s, self-employment in Cuba was legally restricted to individual private ownership (without the capacity to contract labor). The recent authorization of private employment, and thus, the implicit official recognition of the existence of privately held capitalist property—at least at the micro-enterprise level—is one of the most significant conceptual changes in the last 50 years. This new reality, in my view, has conflicts with the Constitution that are in urgent need of correction, and extreme caution is required in its implementation.<sup>3</sup>

Appropriate regulation to avoid the potential accumulation of wealth in certain sectors will not be accomplished through tax measures alone. Promoting certain types of consumption, such as leisure services, durable goods, to facilitate the extraction and redistribution of part of accumulated wealth is also desirable, as long as they themselves do not become sources of concentration of the means of production.

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<sup>3</sup> Article 14 of the Cuban Constitution states that: "In the Republic of Cuba, the economic system is based on socialist ownership of the means of production by all the people and the *suppression of exploitation of man by man (...)*" (Text underlined by the author). See Official Gazette of the Republic of Cuba (2003).

Logically, in order to avoid concentration of capital—a natural result of the expansion of the private sector—cooperative formulas might be favored by tax and related incentives. Nevertheless, since Cuba has had no experience of collective forms of ownership in non-farm activities, the idea requires further development so that implementation specifics can be clarified.

In sum, increased dynamism in several areas of the economy could be anticipated as a result of a more proactive private sector role, given the starting conditions. This could theoretically lead to the relative progress of an intrinsically *anti-systemic* social class, as well as the establishment of mercantile exchange relations defined by material interest, which can negatively impact socialist relations of production, even if they are not immediately compromised. This entails potential risks of capitalist restoration in the medium term. However, the persistence of a model with excessive centralization that disregards real conditions of reproduction also entails a considerable risk of systemic reversion, which is perhaps more dangerous since it is less obvious.

### ***Management Models for State Ownership***

The economic success of the socialist project essentially relies on the effective use of the potential of the so-called “state sector,” which is the quintessential determinant of national performance. So, what should be done with “state-owned” enterprises?

Naturally, it is possible to choose among several alternative management models to optimize the social mission for each company. For decades, Cuba’s principal model has been *centralized state management*, the principal legacy of Soviet statecraft. Under this model, most authority granted to companies is subject to the consideration or decision of the responsible government agency. Consequently, given the significant complexity involved for the “center” to optimize such a large number of decisions, sometimes artificial gaps between demand and supply arise at the microeconomic level. In addition, companies and their workers have tended not to pay attention to economic performance, so that results-based payment systems have been ineffective, and efforts to raise productivity levels become voluntaristic in nature. Another outcome is low levels of outsourcing, given the strong incentives for autarky generated by the centralized model.

Cuba’s most relevant alternative model, which could be described as *decentralized state management*, vests company management boards with wider latitude for decision-making, while retaining some decisions at the central level, including the appointment of the management board. The current changes clearly favor more decentralized business models. However, a shift to decentralized state operations must take into account an important issue: authority cannot be transferred to companies without in the medium term developing mechanisms for effective control (not just participation) by the workers over company decision-making. Management authority cannot be transferred to entrepreneurs, but rather should be subject to the

wisdom and interests of collective power. Otherwise two major risks would arise: (a) continued delay in progress toward the socialization of the means of production, prolonging workers' alienation from their interests, even within the work collective level; (b) a strengthened class of entrepreneurs with *semi-absolute* decision making powers, which in decentralization in Eastern European ex-socialist models served as a catalyst for capitalist restoration.

Moreover, the ongoing debate in Cuba is also exploring new alternatives, such as the temporary transfer of assets that remain under state ownership to *private management*. This recipe is most feasible for activities that, although performed by state-owned enterprises, are in fact closer, due to their scale or kind, to patterns of simple commodity production. In larger-scale entities, formulas similar to management contracts used with foreigners in tourism companies could be tested with Cuban nationals.

There are other alternatives for managing state ownership that are not currently emphasized in Cuba. For example, if decentralization of authority regarding enterprise decisions, including the appointment of top managers, were to fall to the workforce, we would have a form of *collective management*. This is undoubtedly superior to private management, since it guarantees channeling individual effort toward the interests of the collective.

The superior form of managing state ownership, virtually absent as an organic proposal in the new model, is the need for systematic and effective social level control over enterprise performance, as well as all public decisions. Under this alternative, which we call *social management*, productive assets are managed by the State. However, another way of conceiving the State is required, which obviously goes beyond the narrow universe of economic relations.

The means for systematic and proactive participation of citizens in the processes of the nation should be institutionalized, not only as popular consultations on historic events or the most significant transformations, as has often occurred in Cuba. The dialectical relationship behind the *vanguard-masses* concept should exceed the practice whereby the group considered the most ideologically advanced is charged with the mission of generating the means for an organized desire for change. Instead, more direct forms of control over the national direction should emerge, undertaken by a growing number of social actors. István Mészáros, analyzing Soviet-style post-capitalism examples, states that “the paralyzing influence of the overwhelming power of the State over the economy was doomed to failure because the Politburo members had succeeded in arbitrarily awarding themselves the exclusive and supreme role as decision makers in carrying out their variant of a planned economy.” (Mészáros 2006)

For example, it could be worth exploring forms of control over commercial activities through the Organs of the Popular Power at several levels. If the over 3,000 entities existing in Cuba in late 2010, instead of being part of the organizational structures of about 30 ministries and central agencies, had organized themselves into *business groups* at the national, provincial and municipal levels, and their results had been controlled by the Assemblies of the Popular Power at their respective levels, we would have taken a step forward in the construction

of superior forms to socially manage the means of production belonging to society as a whole. Clearly, this would require a redesign of the Popular Power system at all levels by professionalizing deputies and delegates and increasing their actual role, without abandoning the principles of socialist morality. The following issues should be reviewed: members of parliament working full time, rather than just after working hours; the authorities and functions exercised in practice by the Assemblies in relationship to the government; and the electoral process itself, starting with mechanisms for nominating candidates and their representation of society.

### ***Economic Organization of the State***

Another distinctive element of the economic functioning model is the economic organization adopted by the State. A primary consideration is the demarcation between central and local powers in the exercise of state power, in this case concerning its economic functions. This point relates to what Tinbergen called *degree of centralization of the administration* (Tinbergen 1959). Therefore, the power to collect and use public funds and that to exercise social control over nationalized companies are some of the most critical authorities to be defined among different government levels.

In current Cuban practice, provincial and municipal governments have had almost no authority over economic management in their territories. The imprint of strict old-fashioned central planning holds solutions to local problems captive to the priorities set by the central government. Local economic powers are usually limited to complying with and controlling provisions that are centrally issued.

The new model under discussion emphasizes the promotion of productive initiatives that boost local economies, and suggests some degree of increased fiscal autonomy by establishing a territorial tax on locally based state enterprises, cooperatives, and private businesses. However, as noted above, the fact that a certain number of decisions are devolved to local levels is not a solution if procedures are not put in place to assure these decisions are subject to effective forms of social control.

The *functionality of the state apparatus* is another factor that determines the economic organization of the State. The suitability of the institutional design for the effective performance of state functions is made up of three components:

First, a clear delineation of functions performed by the Party, Public Administration bodies and Assemblies of the Popular Power is required; although it has been raised historically by leaders, a deeper discussion on this issue is still pending on what may bring about a consistent and stable solution in practical terms for contemporary Cuba.

The second element is the need to fill gaps, eliminate duplications and contradictions, and ensure the functional mandates of all the agencies of the central state administration (ministries) are consistent and integrated. For example, the Ministry of Finance and Prices is currently faced with a conflict between formulating pricing

policy and administering the approved budget deficit. Between the two mandates, the budget objective prevails since it is enacted into law, which creates incentives for this Ministry to raise prices in state markets (centrally controlled) in order to increase state revenues. Thus, the population ends up financing part of the fiscal deficit.<sup>4</sup>

Third, there is the problem of separating state and business functions; those boundaries shall remain blurred as long as companies remain directly under the authority of the relevant ministries. As long as ministers must ensure compliance with the economic plan and account for the productive results of companies under their supervision, a natural reaction will be to manage these companies directly, while their policy-making (state functions) will be determined by these productive goals. For example, while the Ministry of Fisheries, now merged with the Food Industry Ministry, was in charge of increasing the catch scheme, it was in continuous conflict with its state function to preserve fishery resources, the ecosystem and aquatic wildlife.

In any case, for improved functionality of the state apparatus, there is a need for transparency in economic decision-making processes at all levels, with oversight by various forms of real and systematic public scrutiny.

### ***Structure and Characteristics of Aggregate Markets***

In the framework of any national economy, several markets or areas where resources of various types are exchanged can be differentiated. This is also the case in Cuba, regardless of the fact that these exchanges may be mediated by market relations to a greater or lesser extent, where three markets studied by macroeconomics can be identified: *market for goods and services*, *labor market* and *money and financial market*. Defining the desirable features for each of these markets, which include the structural characteristics of supply and demand, the behavior of principal actors, and the mechanisms for determining prices and quantities, is another component of the national economic functioning model. The design of market mechanisms should be undertaken with full awareness of the objective internationalization of global economic processes, which powerfully connect internal and external markets, even beyond the will of national authorities.

The most significant feature of the *market for goods and services* in Cuba involves supply constraints. This condition precludes the possibility of purchasers' control over producers, so sales of everything in supply are potentially guaranteed regardless of price, quality or selection. It is thus a market where buyers compete among themselves to purchase products, a phenomenon called by Woldzimierz Brus the "tyranny of producers" (Brus 1969).

Although the problem seems to lie in real production constraints, this situation is aggravated by the concentration of production of each line of goods in one or just a few companies, in pursuit of alleged benefits of scale derived from specialization.

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<sup>4</sup>In real terms this is equivalent to charging for social services such as education and health care.

At the same time, this trend creates a market structure that guarantees *quasi-monopolistic* conditions for certain state producers.<sup>5</sup> Although this monopolistic market is essentially different from the type generated by capitalist ownership conditions, it still represents a virtually absolute market power that deepens a power relation in favor of producers over consumers, adversely affecting the quantity, quality, variety and price of commodities.

In order to counteract this phenomenon, high level state agencies have come up with a design that, in an effort to stand in for the nonexistent horizontal control of consumers, tends to exaggerate vertical control mechanisms of the economy. As a result, decision-making autonomy of enterprises has been reduced to a minimum, replaced by highly detailed and rigid norms or regulations. Thus, a monopolistic supply structure tends to lead to a form of centralized state management. In turn, if the functioning model chooses the principle of centralized state management, then the natural tendency would be to raise the levels of production concentration in order to facilitate central administration.

The ongoing process to give greater authority to enterprises and reduce centralized regulatory frameworks will not significantly change the conditions of supply deficit. Nevertheless, it will undoubtedly allow for productive entities to attain extraordinary profits if the monopolistic structure of markets for goods and services remains unchanged. The best thing to do would be to deconcentrate all production other than that deemed strategic for national security purposes.

Another distinctive feature of supply in the Cuban market for goods and services is its highly segmented character, with a wide range of prices. Whenever the state allocates some resources at a special price designed to protect certain sectors of the population, real market forces generate an arbitrage process that reallocates resources through extra-legal market mechanisms. This encourages private sources of accumulation that accrue to sectors other than the intended beneficiaries. This happens because demand, the other market component, unifies all segments created by supply, providing a single actual price that balances total quantities offered by means of demand. While the State is seeking to set a price that is below market equilibrium, it is natural that some agents intervene to appropriate the differential between the official price and the equilibrium price. This also happens because authorities, underestimating the objectivity of economic laws, presume that conditions for the distribution of these resources can be kept under control. Consequently, institutions end up devoting substantial material and human resources to control tasks, naturally without achieving effective results. Stricter controls only strengthen the ability to detect specific violations without addressing the causes of the phenomenon. The absence of an approach to these issues based on the fundamentals of economics is one of the most fundamental reasons why some policies for social protection are not meeting their objectives.<sup>6</sup>

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<sup>5</sup>In addition, there has been an absence, until now, of a non-state sector of the economy to supply potential substitutions for most items.

<sup>6</sup>Over the last few years there have been countless examples in which the State has attempted to sell products at “centrally fixed” prices, while the actual price paid by consumers was much higher.



A related issue is the high-level of heterogeneity that characterizes demand, with very different budgetary constraints among social groups. The “population” can no longer be conceived as a uniform cluster of consumers with similar budgetary constraints and without differentiating preferences. The consolidation of strata with consumption capabilities that are very far apart is a feature of contemporary Cuba that should be adequately considered in the structure of supply.

The imminent emergence of non-state supply under the precepts of the new model merits separate consideration. An important part of the supply that operates with freely determined prices has actually functioned during the last two decades under predominantly oligopolistic conditions. The causes can be found, first, in the multiple barriers to entry established by the previous economic policy, and secondly, in the upward pressure on prices of private producers from the highly taxed substitute and complementary products in the network of state-owned hard currency stores.<sup>7</sup>

Finally, there is a total lack of institutions defending competition in these markets, which need to have the unfortunate, however natural, oligopolistic behaviors eliminated to protect the welfare of end consumers as well as assure space for the emergence of new entrepreneurs. The spaces reserved by the functioning model for market relations should be promoted competitive market structures, which are always fairer and more socially efficient. If current conditions in the development of socialism suggest the recognition of these market spaces, then all necessary measures must be taken to ensure their proper functioning and minimize their social costs. Learning to manipulate market conditions to further the objectives of the socialist project is one of the main challenges Cuba currently faces.

The *labor market*, meanwhile, is another essential component in this equation. The demand for labor in Cuba, which thus far has mostly been a state workforce, has been conditioned by a historical policy of full employment. As a goal of socialism this policy has minimized—to the point of extinction—any trace of the reserve army of labor. Strict regulations that protect workers against any attempt of dismissal—even in presence of a bad worker behavior—coupled with a rigid, low wage structure, lead to this market also being subject to the mandate of supply.<sup>8</sup>

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Prices of services to fix flat tires, prices charged at barbershops and hairdressing salons (before they were leased to self-employed workers), state parking lots, repair shops for home appliances, the appearance of “Coco-Taxis” service in the capital in Cuban pesos, and the free sale of some construction materials, among others, are all examples of how objective conditions have been underestimated.

<sup>7</sup>It is possible that a tax reduction on certain basic goods at the hard currency stores (TRD in its Spanish acronym), may have a multiplying effect on the Consumer Price Index, forcing prices of substitute or complementary products in other markets to follow a downward trend.

<sup>8</sup>Among these wage rigidities are the difficulties of implementing effective mechanisms for payments for results, which are still riddled with the antisocialist practices of establishing a maximum limit of payment for work. Others, like the centralized establishment of nearly homogeneous indicators to set salaries through a few universally applicable scales and with an excessively narrow scope, as well as the lack of indexation of nominal wages to fluctuations in price levels, are not even found in public debates.



Another feature of current labor market demand is inflexibility with regard to part-time employment. Despite the repeal of the ban on holding more than one job (a policy consistent with the previous understanding of full-employment), the effects are limited by scant implementation of part-time hiring in the planned state sector.

The relative mismatch between the skill levels of the labor supply and the actual demand is another imbalance in this market, which leads to one aspect of underemployment in Cuba: workforce underutilization.<sup>9</sup> Given underutilization and a high degree of segmentation in the labor market, the state sector has to compete with other sectors established legally or extra-legally under very unequal terms, since those sectors benefit from a regulatory framework that allows them to pay much higher salaries.

There is another critical issue: although Cuba is an island, given the international development of communication technologies and the effects of the internationalization of production, the notion of a closed economy is totally inapplicable to the Cuban case. Domestic demand for labor must compete with foreign demand, especially from economies where wages are higher, and the Cuban supply has proven to be highly competitive. Internal imbalances in the labor market, therefore, constitute one of the major economic causes in the sensitive topic of current emigration.

Finally, the *money and financial market*, still caught up in the complex network of the prevailing dual currency system, should play a much more active role due to the ongoing expansion of market relations in the national economy. State financial institutions should tailor their activities to the new circumstances, expanding access to credit and making the terms more flexible, and objectively addressing the financing requirements of non-state enterprises. Otherwise, an existing private financial sector will grow stronger, one in which the accumulation process is beyond control due to its informal character.<sup>10</sup> Moreover, external private financing is increasingly easier to obtain, including by those with explicit goals to subvert the national political order.<sup>11</sup>

State supply in this market must establish a coherent interest rate structure in the short term, allowing for a more objective approach to the real cost of money in the management of the domestic economy. The much needed devaluation of the official exchange rate of the *peso* against the *CUC*, and the integration of both currencies for use by the population and business segments, is the starting point for monetary restructuring of the economy.

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<sup>9</sup> Thus far, the officially approved self-employment activities do not deploy existing high levels of qualification.

<sup>10</sup> Although the sample studied is not statistically significant, it appears that the private credit market has considerably expanded in response to the increase in self-employment, and is operating with short-term interest rates close to 50 %.

<sup>11</sup> After the announcement in 2011 of the opening to private employment in Cuba, the US President approved a measure authorizing US citizens to send remittances to Cuban citizens residing on the Island. The Brookings Institution hosted a panel in February 2011 confirming the strategy to soften the blockade in areas that could be key for private sector expansion in Cuba (Brookings Institution 2011).

### ***Regulating Production: A Planning Approach***

This aspect requires the determination of society's role in implementing mechanisms for regulating production versus automatic market development. Direct state intervention in economic relations is usually aimed at regulating one or another aspect of reproduction, by ordering, influencing, or replacing market self-regulation.

Historically, all efforts to build socialism along the lines of the Soviet model were distinguished by a form of state intervention that was highly centralized and detailed. Indeed, the founders of Marxism envisioned the organization of a new society based on centralized ex-ante regulation of production, but this was designed for a phase of society that has never been reached. Thus, this notion of planning, which was disseminated as a systemic principle rooted in Marxist orthodoxy and established over many years, comprises a severe inconsistency since it was implemented at the wrong time.

Another feature of this view of planning is the direct distribution of physical resources based on specific administrative goals that are achieved by large-scale use of political incentives and patriotic appeals to productivity and work discipline.

However, these mechanisms are not exclusively associated with socialism; they are features of wartime or emergency economies that have also been used in many capitalist countries.

These methods, which are indeed necessary and useful in the early stages of a social revolution, can become an obstacle to subsequent economic progress when they persist beyond their historic justification, given their lack of flexibility. According to Oskar Lange, the problem begins when "these methods of wartime economy are identified with the essence of socialism and are considered to be inextricably linked to it." (Lange 1957)

On the other hand, according to Lange, planning means every effort made to "subordinate the action of economic laws and economic development of society to human will," which can also be achieved by using other instruments, identified in this paper as instruments of indirect regulation (Lange 1957).

Under the current Cuban model, it is a common mistake to associate planning with direct administration of scarce resources as the operational nature of the economy. This logic suggests that there will be more planning as more resources are subject to physical regulation by the central government.

As part of the interpretation of the call issued by the country's top leadership to increase the effectiveness of planning, what is happening now is an unsustainable expansion of the physical number of products within the purview of the "plan." This is a major inconsistency, given the financial nature of Cuba's external economic links, as opposed to their material nature within the former Council for Mutual Economic Assistance (COMECON) in the 1970s and 1980s.

The dysfunctional coexistence of measurement and management practices based on physical magnitudes with analyses based on financial indicators introduces severe distortions, the origin of which lies in the functional design of institutions as

well as the idea behind the planning concept. For example, while the Ministry of Finance is solely responsible for budget development, implementation and control in Cuban pesos (CUP), the Ministry of Economy is accountable for material resources and hard currencies, through the allocation of Cuban Convertible Pesos (CUC) and discretionary use of the power to purchase foreign exchange. As a result, the physical functioning of the economy is inconsistent with its financial side.<sup>12</sup>

Moreover, the plan development in Cuba has to follow a troublesome mechanism that turns the system's most important economic process into a battlefield. Under this mechanism, state businesses and agencies deploy diverse schemes to compete for the greatest possible amount of resources allocated by higher authorities, which they legitimate by the defense of social interests for which they are responsible. Historical practice has led to the custom of basis production units reporting underestimated capabilities and overestimated needs, while central levels allocate resources below requested levels and demand more ambitious goals than those set at the basis level. The principal argument for discussion is the previous year's performance, which is perennially required to be surpassed, using fewer resources each time. Each party is aware of the other party's philosophy, so the procedure becomes in reality a bargaining process, and the final result is administratively determined at the central level.

The first Guideline from the sixth Congress of the Communist Party of Cuba (PCC) states that in the new economic model, "The socialist planning system will continue to be the principal management tool for the national economy, and its methodology, organization and regulation must be modified, (...) taking into account the nature of the market that affects it." (PCC 2011)

However, maintaining centralized planning while accepting the growing presence of decentralized modalities (including private ones) requires a profound technological change in the design and implementation of planning at all levels.

First, it implies acknowledging the objective existence of the market, and given the objective conditions that sustain it, this recognition seems already explicit. Second, the areas or activities to be regulated by the market need clarification, leaving the state planning agencies in charge of estimating their activity levels for using as a data. Third, in areas reserved for State regulation, we should define the activities to continue under direct regulation and those that must switch to indirect regulation through macro and microeconomic policies. Finally, in areas directly regulated by the State must have an economic base rather than a discretionary administrative nature. Thus, prices and quantities that are centrally established should take into account market equilibrium levels, otherwise artificial pricing will remain unchanged, making room for private intermediaries who appropriate the benefits of arbitrage.

Under the current and foreseeable conditions of the Cuban economy, modifications in the regulation of production are necessary. First, financial planning should

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<sup>12</sup>Not to mention the general problem of pricing, whether price determination for the centralized sector or indirect regulation of prices for the decentralized sector, which is one of the most serious problems currently facing the Cuban economy. This issue still has not received sufficient attention, not even by the academic community.

be decisively applied, which has the obvious advantage of reducing the complexity of resource allocation. Material balances should only be permitted in sectors restricted from the standpoint of physical supply, and incorporated into the overall equation as capacity constraints.<sup>13</sup> Then, the regulatory framework has to ensure that financial results of entities correspond to those from the real sector.<sup>14</sup>

Furthermore, increased enterprise autonomy is essentially contradictory to regulation through predominantly vertical directives. Similar problems, among other reasons, thwarted efforts to decentralize in the late 1970s, limited the performance of agricultural cooperatives launched in the 1990s, and frustrated the potential for business improvement.

Moving forward, the growing activity of non-state sectors, as well as the expanding state sector, will require greater use of indirect regulation through macro and microeconomic policies.

Another major challenge is creating a new institutional organization with real capacity to respond to changing circumstances and planning objectives. A more comprehensive notion of planning is needed that in addition to designing and implementing economic policy, organically incorporates social, cultural, technological and environmental policies, among others. This new organization would involve a multidisciplinary institution charged with long-term planning capable of instituting an integrated approach. By transcending the narrow context of the economy, this institution should approach planning as a way to lead society as a whole towards the attainment of socialist development objectives.<sup>15</sup>

### *Relative Weight of the Various Sources for Wealth Distribution*

Survival of the socialist path depends, among other things, on the possibility of sustainably harmonizing the distribution of social wealth with the notion of individual aspirations. Thus, the expansion of wealth created should be coupled with the promotion of socially responsible consumer expectations, in line with a rationale

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<sup>13</sup>For example, if restrictions on power supply are caused by rising prices for fuel imports and not by electrical generating capacity, then its allocation process should be limited through financial indicators, not material ones. If instead of allocating a fixed subsidized amount of kilowatts to an entity, an amount in CUC is allocated, and power supply is charged at a price that reflects the country's real costs, then electricity could be generated in the amounts entities are willing to pay for, in exchange for a reduction in other expenditures. The current policy is following a completely different rationale.

<sup>14</sup>In order to avoid repeating mistakes made in the 1975–1985 period under the implementation of the Economic Direction and Planning System, the goal should be, for example, that a construction company only obtain revenues once work is completed, and all its operating expenses—including wages—are covered with working capital or bank loans.

<sup>15</sup>In South Africa and Vietnam, this kind of institution has been created under the rubric of a National Planning Commission. In the case of China, this role is performed by the National Commission for Development and Reform.

different from systemic capitalist consumerism. So, how is this collectively created wealth distributed to each individual?

As far as Cuba is concerned, the model consolidated during the 1980s was based on an ideal of artificial equalization. In 1985 only an estimated 49 % of total consumption of goods and services was obtained through labor, while the remaining 51 % was attributable to subsidies and services available free of charge derived from social consumption funds.<sup>16</sup>

Under present conditions, although estimates of sources for ultimate consumption are complex, it is fair to assume that labor remains marginalized. The high proportion of egalitarian-oriented social avenues for consumption that characterized social policy since the early decades deepened with efforts to distribute the impact of the crisis during the 1990s, as well as in policies instituted after 2000.

In recent years, this situation has been compounded by the proliferation of several means to access goods and services that are not related to the social utility of the work performed. These two factors, in conjunction with the low purchasing power of public-sector salaries, cause perhaps the most serious damage to the legitimacy of socialism in Cuba, and are fundamental causes of the current and historic low levels of labor intensity.<sup>17</sup> Indeed, in 2009 only 49 % of the population's income came from jobs in state agencies, although about 84 % of the working population was employed in this sector (National Statistics Office—ONE, in its Spanish acronym, 2011).

The new model has to offer alternatives to individuals for them to pursue their life goals in keeping with the objectives for constructing socialism. During the 1970s and 1980s, the aspirations of youth were clearly feasible in the framework of collective aspiration, since implicit rules of social mobility were clearly in line with the objectives of the project for a new society. However, after the Cuban crisis at the end of the century, the capacity of the reemerging social project to offer opportunities for individual integration and prosperity based on work contribution was severely damaged, even to the point of undermining capacity to meet basic needs within the law. The situation generated perverse signals that led to social acceptance of values inconsistent with emancipatory paradigms historically advocated by socialism.

Real options for meeting immediate needs were reduced to a few alternatives. One such option is holding a key position in an institution or company that can provide access to non-wage resources, including goods or services that are part of formally institutionalized distribution schemes. Opportunities to obtain a personal vehicle and, in many cases, housing, are some of the most notable incentives, although these are actually privileges only in relative terms, since they are necessary

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<sup>16</sup>Income not associated either with labor or social consumption funds was insignificant during this period. Exploitation of individuals' labor was virtually eliminated and privately generated income was extremely limited. See Ferriol, Ángela (2001) for further details.

<sup>17</sup>The term labor intensity is used to differentiate it from the concept of productivity, which is also dependent on factors such as technological innovation, capital-labor relations, and others that are not directly attributable to workers' performance.

to reproduce labor, but are not accessible at the real wage rate. This does not mean that everyone who achieves one of these positions is motivated by personal gain. The willingness to sacrifice for the collective well-being is part of the system of values promoted for decades, and it is still a determining factor in the performance of many officials, leaders, and workers in general. However, the attempt to compensate for the limitations of the distribution mechanism using *discretionary administrative benefits* threatens to permeate the decision-making of some managers as part of a self-preservation instinct that tends to evolve along classist lines, even if unconsciously.

In some positions, highly destructive phenomena are emerging, including the illegal appropriation of resources, influence peddling, and the apparently idiosyncratic accumulation of relational capital as a long-term guarantee. In sectors such as gastronomy, tourism, fuel distribution, trade, the department of housing, retail, some of these positions are even sold for large amounts in underground markets, given their significant financial potential. This is perhaps the principal form of exploitation of labor currently practiced, and the main threat to systemic values.

The remaining avenues to individual prosperity exist in private economic activities, both licit and illicit, and the not inconsiderable economic emigration, which was not addressed in official discussions held at the sixth Congress of the Communist Party of Cuba.<sup>18</sup>

Obviously, the issues discussed above should be the focus of economic policy. The nerve center of this reality is made up of the following: state workers, in addition to feeling they do not own the means of production, begin to identify antagonisms with the State as their employer, and can even view their relationship with it as class conflict, given the cultural heritage of the previous capitalist system, influences from the international environment—which is also capitalist, and as a result of internal errors made in building the new society.

Therefore, the reorganization of resources for distribution is a strategic factor in the systemic perpetuation of socialism. Real personal income derived from employment should reach magnitudes consistent with the requirements to boost productivity, which means ensuring basic conditions for the reproduction of labor and meeting the expectations of the lifestyle to which the society aspires.

## Conclusions

In the call to “update” the Cuban economic model, a strong consensus has been reached on the need for change. However, real capacity to implement transformations depends on a set of factors that transcend the will to change of the country’s political leadership. Influences created over the past 50 years of a quasi-static

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<sup>18</sup> However, President Raúl Castro, at the closing ceremony of the seventh Session of the National Assembly on August 1st, 2011, announced that the migration policy would be reviewed. A few months later it was approved the new much more flexible policy. See Castro, Raúl (2011).

centralized model, which has become removed from many of the objective laws governing social change, and the proclaimed intention of substantially modifying that model, form a complex dynamic of conceptual construction–deconstruction, which will require several years of practical contradictions and conflicts.

The implementation of the *new model* will have to deal with the threat that the current competition of the binomial dogmatism-pragmatism poses the only set of alternatives. In opposition to the intransigent dogmatism established as a cultural heritage of the Soviet model to the exclusion of all others, there is a risk of walking along the dangerous path of excessive economic pragmatism without a profound debate about what contemporary Cubans understand by socialism. The definition of the features that should characterize Cuban society within a generationally feasible period would allow progress toward bridging the gaps, bringing about greater coherence among economic, social, environmental, cultural, and educational policies, among other essential issues comprised within an inclusive conception of the scientific approach to socialist development.

The success of the ideas currently in play will depend on the objectivity and accuracy of the sequencing or critical path of implementation; truly scientific content informing decisions; training in economics for the leadership and their real willingness to change the status quo; and also on the stability of foreign economic relations amid growing efforts and opportunities for subverting the national political order.

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# Chapter 4

## Current Problems in the Cuban Economy and Necessary Reforms

Mauricio De Miranda-Parrondo

### Introduction

The serious economic crisis of the 1990s brought to the center stage of Cuban academic and political discussion the need to introduce important changes in the economic mechanism, since the crisis of the centrally controlled economic model which led to the disappearance of the socialist system of world economy had become evident.

Nevertheless, in spite of the urgency of the situation and the need for these changes, Cuban political management has for many years been reluctant to introduce changes to the economic system or its economic policy. As far back as 2006, the current President of the Council of State and Government,<sup>1</sup> Raul Castro, announced the need for changes in the economy, and initiated a new debate on economic matters, but few advances have been made since that time.

The delay in holding the sixth Congress of the Cuban Communist Party (CCP)<sup>2</sup> showed the probable lack of necessary consensus among the Cuban leadership with regard to the type and scope of the measures to be adopted, which became clear during the wide-ranging debate of the “Guidelines for the Economic and Social Policy of the Revolution,” which were finally approved by Congress.

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<sup>1</sup> Between July 2006 and February 2008, Raúl Castro was interim president of the Council of State, when Fidel Castro transferred his powers due to illness.

<sup>2</sup> The fifth Congress of the CCP was held in 1997, while the sixth took place between April 16 and 19 of 2011. The statutes provide that congresses meet once every 5 years, nevertheless 14 years elapsed between the last two.

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These Guidelines, however, lack the precision necessary regarding the type of measures which would be adopted. Several months have passed since the sixth Congress of the CCP, and until now the only measures to have been taken are decisions allowing more flexibility, namely, authorization for the purchase and sale of automobiles and property.

The purpose of this chapter is to determine which economic reforms are the most urgent, with a view to dealing with the most difficult problems facing the Cuban economy, after a long and acute structural economic crisis which has seriously affected Cuban society.

## **Current Problems of the Cuban Economy**

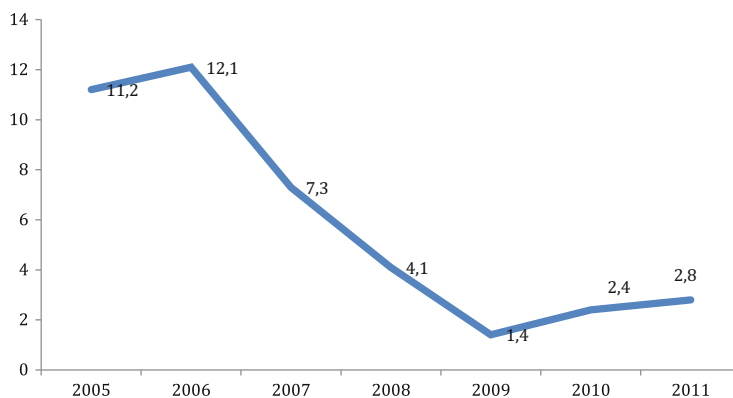
The crisis of the 1990s and the subsequent performance of the Cuban economy have demonstrated that without far-reaching reforms it will not be possible to overcome the serious structural problems of the economy.

The problems which presently affect the Cuban economy can be summed up by the following: (1) insufficient and distorted economic growth in favor of the social services with little impact on the improvement of the quality of life of the population, (2) stagnation of industrial and agricultural production, (3) limited capacity of effective demand, (4) limited sources for the accumulation of capital and insufficient financing, (5) deficient international insertion, and (6) low level of institutional credibility in relation to business.

### ***Insufficient and Distorted Economic Growth in Favor of the Social Services with Little Impact on the Improvement of the Quality of Life of the Population***

Since 2004 the Cuban government has been using its own method for estimating macroeconomic aggregates, which does not adjust to the methodological standards of the ONU. Basically, the Cuban government's method has meant an over-valuation of the social services which are no longer valued according to the State's budget (which is their only real price in the case of Cuba), and to be valued instead as "international prices." This rather unorthodox method of calculating the contribution of social services in Cuba has not been recognized by international organizations.

This unusual way of measuring the gross domestic product (GDP) resulted in the statistical illusion of a significant over-valuation and exaggerated growth of this indicator, especially in 2005 and 2006, when the country exported professional services which, did not nevertheless represent an increase in the country's real income, since for accounting purposes they were valued at international market prices, and



**Fig. 4.1** Growth of GDP in Cuba 2005–2011. *Source:* Oficina Nacional de Estadísticas (ONEI), 2012a, b. [www.one.cu](http://www.one.cu)

not those which, indeed, were established in the governmental agreements which served as a framework for the aforementioned service exports.

Nevertheless, in recent years the slowing down of economic growth has become evident, reducing the impact of the statistical overvaluation.

As can be seen in Fig. 4.1, between 2007 and 2011 Cuba's annual GDP growth was falling, and on average in annual terms shows a growth of 3.1 % for the period. Only during the two last years have there been a slight recovery of 2.4 % and 2.8 %, respectively, while the Latin American and Caribbean region as a whole reached growth of 6.0 %.<sup>3</sup>

The weakness of Cuban economic growth is clear to see if one takes into account the fact that the production of goods represents the area of worst economic development, resulting in a halt in growth, mainly of service activities.

As can be seen in Table 4.1, the productive activities of goods and basic services have shown irregular performance in recent years, especially in activities which are highly sensitive for the consumption level of the population, as is the case with agriculture, fisheries, construction and trade. Negatively highlighted are the annual average decreases relating to the sugar industry, fisheries and construction.

Social services present a significant increase, due among other things to the export of professional services involving doctors, teachers, sports trainers and cultural instructors, as well as the investment process introduced for the repair of hospitals and schools.

In recent years Cuba's economic growth has not had a substantial impact on the level of consumption of the population. Historically, this component of aggregate demand has been pushed into the background, which has brought about a situation

<sup>3</sup> The calculations of annual average growth have been made by the author based on Cuban National Statistics Office (2010, 2012).

**Table 4.1** Average annual variation of GDP per type of selected economic activity, 2007–2011

	2007	2008	2009	2010	2011	2007–2011
Agriculture, livestock, and forestry	19.6	0.6	3.3	-2.8	5.0	4.9
Fisheries	1.7	1.4	4.7	-4.2	-12.1	-1.9
Mines and quarry exploitation	4.0	3.2	-3.3	8.2	1.4	2.6
Sugar industry	-3.4	15.8	-1.4	-16.4	5.0	-0.6
Manufacturing industries	10.1	4.9	-0.1	1.5	3.9	4.0
Electricity, gas, and water	7.9	0.6	0.8	-0.8	2.7	2.2
Construction	-8.6	2.4	0.6	-12.2	-7.3	-5.2
Transport, storage, and communications	6.4	6.6	2.5	2.8	5.5	4.7
Trade	-0.3	-3.4	0.1	1.8	5.5	0.7
Hotels and restaurants	4.9	10.2	10.0	6.3	9.1	8.1
Financial services	9.2	5.3	1.3	0.3	1.2	3.4
Science and innovation	10.0	24.4	10.7	7.8	78	12.0
Education	9.1	3.1	1.5	4.5	-5.3	2.5
Public health	21.0	12.7	3.4	5.7	3.4	9.0
Culture and sports	13.8	1.2	0.6	7.8	-1.8	4.2

Source: ONEI (2009, 2010, 2012a, b)

Note: The annual average variation is calculated by the author

of unsatisfied needs on the part of the population. Between 2007 and 2011, the average annual growth of home consumption was only 1.9 %, <sup>4</sup> less than the growth in GDP overall.

### *Stagnation of Industrial and Agricultural Production*

As can be seen in Table 4.1, industrial and agricultural production show signs of limited and insufficient growth. If we disregard the atypical agricultural production of 2007, average annual growth between 2008 and 2011 was only 1.5 %. <sup>5</sup> In the case of the sugar industry, the volatility of growth between 2007 and 2011 is clear. In 2008 this grew to 15.8 % (but based on the extremely low production levels of the previous period), and in 2010 it contracted by 16.4 %, and in 2011 it increased by 5.0 %, producing a negative annual average growth of -0.9 % for the period. Meanwhile, the rest of manufacturing industry shows an average annual growth of 4.0 %, albeit boosted by an atypical growth of 10.1 % in 2007.

In terms of physical volume, Cuban industry overall in 2011 was at 45.1 % of the country's 1989 production, of deindustrialization and quasi-paralysis. In the case of the sugar industry, production in 2011 was only 16.4 % of the 1989 figure. The industrial sector overall only reported growth in the aforementioned year in the areas of furniture production, pharmaceutical products, metal products and the

<sup>4</sup> Author's calculations based on ONEI (2012a, b).

<sup>5</sup> Author's calculations based on ONEI (2010, 2011, 2012a, b).

production of beverages. For the same year food production was at 67.7 %, textile production 2011 6.8 %, petroleum refinement 50.3 %, production of leather and leather goods 17.1 %, and rubber and plastic products 19.6 %, among others (ONEI 2012a: Chart 11.1).

In general terms, Cuban industry is suffering from problems of technological obsolescence, limited capital resources, as well as a chronic shortage of raw materials and fuel, which has been affecting it for several decades.

Agriculture continues to produce inadequate results. In 2009 and 2010 the majority of crops showed production figures lower than those of 2006, as is the case of subsistence crops (tubers, roots, bananas), vegetables, tobacco, citrus fruits, and cocoa (ONEI 2012a: Chart 9.9).

Cuban agriculture continues to be affected by a series of structural problems. There is a contradiction—which has no solution—between the coexistence of different forms of land-based property and the execution of non-state forms of property. State controls over the agricultural market with regard to prices as well as its own structure, the persistent limitations of the capital goods market for agriculture, the scarcity of industrial supplies and seeds, are factors which limit the sector's recovery. In addition there has not been sufficient stimulus for the recovery of agricultural markets to ensure higher productivity indices which would permit the reduction of dependence on imports, which seriously affect the country's balance of trade.

### *Limited Capacity of Effective Demand*

The effective demand of the Cuban population is insufficient to stimulate production from the domestic market. This is fundamentally due to the low real income of the population, the recent reduction of remittances from abroad due to the international economic crisis, as well as reduced income from international tourism.

The low level of real income of the population is due to the fact that the major part of income is derived from salaries which are fixed by the State and which do not correspond to the level of real prices which exist in the domestic market. The Cubans' basic needs of food, clothing, footwear, transport and leisure are not met by their earnings, and for this reason the high level of remittances has been an additional source of income which has helped Cuban families to ease the chronic shortfall in their needs which, nevertheless, does not translate into increased effective domestic demand.

Persistence with the dual currency system which divides the market into one type of Cuban peso currency, in which salaries are paid, and another type, the convertible peso (25 times the value of a Cuban peso), in which market prices are fixed for the majority of goods and services which are traded freely in the country, makes the insufficient level of effective demand even clearer.

The prices of goods and services offered by the stores in convertible pesos, maintain a certain relation with world prices, those which include a high circulation tax

(around 240 %) which is received by the State. Meantime, the average monthly salary in the country is 448 pesos, the equivalent of almost 18 convertible pesos, which is obviously insufficient to cover basic consumer needs.

In the same way, income from foreign currency, the product of tourism, at least allows those who work in the sector a source of supplementary income in the form of tips which subsequently enter the national money flow. Nevertheless, in recent years, even though the number of tourists has increased, gross earnings from tourism have decreased.

### ***Limited Sources for the Accumulation of Capital and Insufficient Financing***

In present conditions, there are no other sources for the accumulation of capital than those of the Cuban State itself, or foreign direct investment. The setting up of a controlled centralized economy, and in particular since 1968, with the “Revolutionary Offensive,” prohibited the existence of private businesses which produced profits for their owners, thus completely ruling out private capital. On several occasions, with authorization for people to work on their own account, self-employment has been allowed with limitations which have slowed their growth, preventing surpluses which would lead to the generation of private capital.

The Cuban State lacks sufficient resources to ensure the investment needs required by the economy at the present time. The slow growth of the country’s economic activity produces insufficient resources for the State’s budget, which is a significant limitation for public spending and domestic investment, above all due to the need to maintain a relative fiscal orthodoxy which would avoid a crisis such as that of 1990–1993, in which the deficit reached levels approaching one third of the Gross Domestic Product (GDP).

As can be seen in Fig. 4.2, the State’s income from taxes and other non-tax sources has remained relatively stagnant over the past 3 years. In the meantime, public spending has maintained a downward trend until a little increase in 2011.

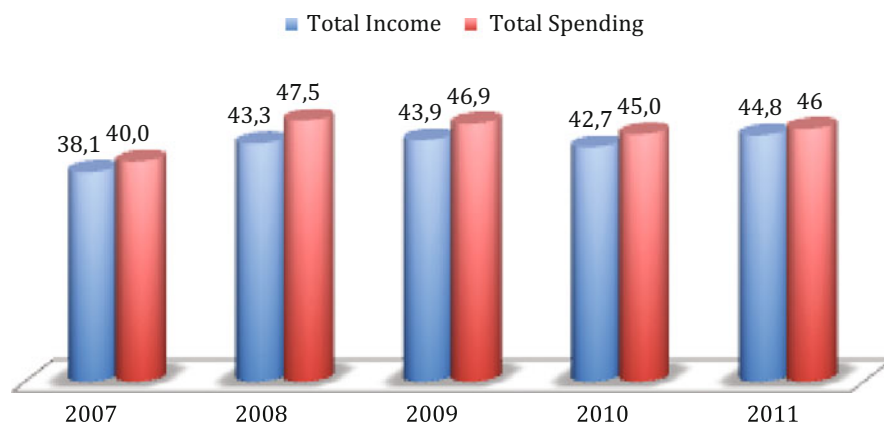
The State’s budgetary limitations for undertaking investment are expressed in the downward trend of the gross capital formation of the island in recent years.

As can be seen from Table 4.2, in the last 4 years, the extent of total investment in the country has fallen, especially in construction and machinery.

There is no recent data available on the flow of foreign direct investment into Cuba. The Cuban national statistics office (ONE) has not updated data on the country’s current account since 2009.<sup>6</sup> CEPAL’s “Overview of direct foreign investment in Latin America and the Caribbean” excludes Cuba in its statistics. Only Unctad shows estimates in its “World Investment Report, 2010” which calculates the FDI in

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<sup>6</sup>The Cuban Statistical Yearbook of 2011 (2012 edition), which is the most recent to be published in Cuba, only provides data of the Current Account Balance until 2009, therefore no series of recent data exist of the Financial Account, which includes foreign investment movements.



**Fig. 4.2** Income and total spendings of Cuban budget (billions of pesos). *Source:* (ONEI 2012a, b: Chart 6.4)

**Table 4.2** Gross fixed capital formation (millions of current Cuban pesos)

Sectors	2007	2008	2009	2010	2011
Total	5,677.8	6,583.5	5,385.9	5,561.4	5,319.8
Construction	3,127.0	3,446.7	3,287.2	3,341.7	3,220.1
Machinery	1,572.8	1,976.8	1,193.9	1,180.7	1,113.6
Other investments	858.1	942.1	799.1	848.4	802.9
Capitalizable repairs	119.9	217.9	105.7	190.6	183.0

*Source:* ONEI (2012a, b: Chart 5.16)

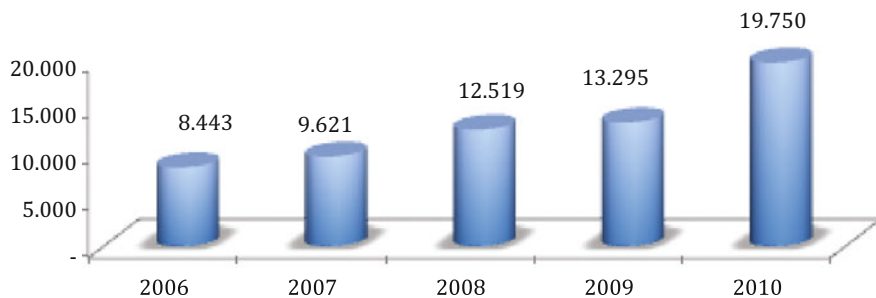
Cuba as 64 million dollars in 2007, 24 million in 2008, 24 million in 2009, 86 million in 2010 and 110 million in 2011 (Unctad 2012 Annex, Table 4.1). These figures show a marginal contribution of Foreign Direct Investment to the process of gross fixed capital formation in the country in recent years.

On the other hand, the restrictions which have historically been imposed on the development of private business in the country have limited the possibility of private domestic contribution to the process of capital accumulation. It is clear that domestic sources are extremely limited, but based on the growth of certain private businesses, it would have been possible to develop a fabric of businesses which would include some craftwork production, farming production, and certain services which would have contributed to the capital accumulation process to support investment and economic growth.

The problems of financing have become chronic for the Cuban economy. The shortage of domestic resources is aggravated by limited foreign resources. The flow of foreign direct investment towards Cuba is expected to have been marginal in the last few years.

Also, it is supposed that the country's external debt has been growing in recent years even though there have been no official figures since 2008.<sup>7</sup> Figures of external

<sup>7</sup>The Cuban Statistical Yearbook of 2011 only provides external debt figures for 2007–2009.



**Fig. 4.3** Cuban foreign debt de Cuba (millions of US Dollars). *Note:* The values in US \$ between 2006 and 2009 are calculated based on the value of the average official exchange rate for each year (0.9231 CUP per USD in 2006, 0.9259 from 2007 to 2009). *Source:* For 2006–2008, ONEI (2011: Chart 8.2), and for 2009 and 2010, CIA (2012)

indebtedness have always been very politically sensitive because they could show the country's level of external vulnerability (Fig. 4.3).

The estimates of the CIA, which could be biased, consider Cuba's creditors as sources, whereas in reality these debts correspond to Venezuela and China, which are the country's main trading partners. The trend, even in the 4 years officially reported, is the increase in the size of the debt. It should be noted that between 2006 and 2008, 32.9 %<sup>8</sup> of the country's total debt was with suppliers, that is, debt originating from foreign trade operations which present a situation of relative insolvency, reflecting relative under-supply, even in the stores that sell articles in convertible pesos.

Cuba's international reserves are another closely guarded secret by the Cuban authorities. CIA estimates put these at 4,847 million dollars at the end of 2010 (CIA 2012), which represent scarcely 24.5 % of the total debt, if both estimates are correct.

### ***Deficient International Insertion***

Insufficient external financing is closely related to deficient international insertion.

The situation of a constant shortage of foreign exchange is clear in the trend shown in the Trade Balance, especially that of Current Account (see Table 4.3).

The Trade Balance shows a marked shortfall. Cuba's import needs have increased in capital goods as well as in intermediate and consumer goods. The virtual paralysis of the manufacturing industry, insufficient food production and the need for fuel, together with the increase in raw material prices have brought about a sustained increase in the country's import needs, which is not matched by a similar increase of exports.

<sup>8</sup> Calculations based on the sum total of debts with suppliers as a proportion of the external debt of the 3 years (ONEI 2011, 2012a, b).



**Table 4.3** Current account balance (millions of Cuban pesos)

	2006	2007	2008	2009	2010
Current account	-214.6	400.6	-2,308.8	-162.4	N.A.
Trade balance	-6,330.3	-6,265.0	-10,372.7	-5,917.4	-6,094.8
Exports	2,924.6	3,685.7	3,664.2	2,863.0	4,549.5
Imports	9,497.9	10,079.2	14,234.1	8,906.0	10,644.3
Balance of services	6,456.0	7,824.3	8,637.2	7,163.0	N.A.
Income	-618.0	-959.7	-1,055.2	-1,643.0	N.A.
Net transfers	277.7	-199.0	481.9	235.0	N.A.

*Note:* The Trade Balance values shown between 2006 and 2008 do not coincide with the algebraic sum of their parts because they include the value of sales in ports and airports which have not been considered in the total of exports and imports

*Source:* Author's calculations based on ONEI (2012a, b: Charts 8.1 and 8.2) and the official exchange rate applicable in the respective periods

The absence of official data limits analysis of the country's external economic conditions. It is, however, clear that the trade imbalance in goods that is not compensated by the surplus of the balance of services, together with the capital income account, has a deficit trend in the Current Account, except in 2007, when the income from services appears out of proportion due to the impact of the export of professional services to developing countries, especially Venezuela.

Cuba has maintained a pattern of international insertion characterized by its role as an exporter of raw materials and importer of industrial goods. This has been the case throughout its history, and which has not basically changed, neither in the stage of insertion into the world socialist economy, nor now, when it has been looking to reinsert itself into the global economy. What has changed in the country's international insertion is the increasing weight that services have had, based on the substantial increase of income from tourism and the export of professional services.

The lack of official data of the breakdown of the balance of services<sup>9</sup> does not give us information on the volume of perceived income from the export of professional services, which seems to be the country's main source of income at the present time, followed by that from tourism and the export of minerals, especially nickel.

As shown in Table 4.4, the principal sources of export income show signs of stagnation in the medium term.

Income from international tourism in 2010 was at levels near to those of 2007 and in 2011 was slightly higher.

Nickel exports, which represent an overwhelming majority of mineral exports, recovered in 2010 and 2011 compared with 2009, but are substantially lower than in 2007. This phenomenon has occurred in the middle of a shortfall trend in production in recent years. In 2010 the production of nickel laterite fell by 36.4 % with respect

<sup>9</sup>The most recent Cuban Statistical Yearbook is short of information on the external sector, especially on the structure of the balance of services. Information on the Current Account shows net data for the period 2007–2009, and does not show a breakdown of exports and imports. In a previous work by the author (De Miranda 2008), exports of professional services for 2007 were estimated to have reached 4,686.8 million pesos.

**Table 4.4** Main income from the export of goods and services (millions of Cuban pesos)

	2007	2008	2009	2010	2011
Export of goods	3,685.7	3,664.2	2,863.0	4,549.5	6,041.0
Sugar industry	203.0	235.8	226.4	266.2	388.8
Tobacco products	255.0	253.2	229.2	202.1	223.4
Mineral products	2,311.3	1,598.4	940.2	1,151.3	1,414.3
Gross income from tourism	2,236.4	2,346.9	2,082.4	2,218.4	2,503.1

With the exception of income for the export of professional services

Source: ONEI (2012a, b: Chart 8.7)

**Table 4.5** National production, imports, and consumption of energy-related products (millions of tons)

	2007	2008	2009	2010
Crude petroleum production	2,905.0	3,003.1	2,731.3	3,024.8
Production of oil derivatives	2,301.1	5,193.7	5,185.5	5,003.2
Crude petroleum consumption	5,006.6	4,753.0	4,942.4	4,925.2
Oil derivatives consumption	7,634.4	7,303.6	7,241.2	7,107.8
Crude petroleum imports	2,155.7	4,848.5	5,536.2	5,048.7
Imports of oil derivatives	2,901.9	1,328.6	763.6	3,771.5

Source: ONEI (2012a, b: Charts 10.4, 10.5, 10.7, 10.9, 10.10)

to 2009, and the production of laterite and nickel-rich serpentine was down by 7.9 % (ONEI 2011: Chart 10.2).

The sugar industry is a pale reflection of what it was in past times. The income from sugar exports has fallen considerably as a result of the dramatic drop in production to levels close to those at the beginning of the twentieth century.

In general terms, a substantial increase in Cuban exports would depend on a substantial increase in the prices of products exported by the island, or a combined increase of this and production capacity. Nevertheless, the production trends of the island's principal exportable products do not show signs of significant increases.

The great dependence of Cuba on foodstuffs, fuel and machinery brings to a close this scenario, which represents a deficient insertion of the country into the world economy.

From 2007 to 2011 fuel imports represented 45.6 % of the country's imports, machinery and transport equipment 14.0 % and foodstuffs 13.3 %.<sup>10</sup>

According to Table 4.5, imports of crude as well as of by-products, guarantee a significant proportion of the country's petroleum demand. Unfortunately, no official data is available for 2011.

Cuba's high dependence on imports of foodstuffs, machinery and fuel, and the lack of a significant exportable offer generates great external vulnerability and deficient international insertion.

<sup>10</sup> Author's calculations based on the ONEI (2012a, b, Chart 8.10).

### ***Low Level of Institutional Credibility in Relation to Business***

The economic system which has predominated in Cuba during the past five decades has been characterized by excessive centralization and governmental control. Its highly ideologized economic policy has severely restricted private initiative, entrepreneurship and market activity. Since the outbreak of the economic crisis in the 1990s, aggravated by the disintegration of the world socialist system, Cuba's economic policy has been aimed towards allowing the existence of certain areas of the market which are under strict government control, in other words, that which does not come into conflict with the unlimited control of the main driving forces of the economy.

Attempts have been made to find foreign investment to reactivate the areas of production and service, but direct access of investors with regard to the labor market and goods is limited. The State continues to control the direct hiring of workers and the distribution chain of goods and services in the domestic market.

In past years considerable debts have been accumulated with overseas suppliers which have caused them financial difficulties, leading in turn to a distrust of the country's liquidity when attending to its financial obligations. This situation becomes still more serious if one considers that Cuba does not belong to any of the world, or even regional multilateral credit organizations.

The imposition of the so-called "convertible peso" as a currency for transactions which include foreign economic subjects, has led to a monetary duality which complicates the relationships between the two markets, which appear as a consequence of the use of two different currencies in the national economy. Furthermore, monetary policy has been guided towards an overvaluation of the convertible peso, which has harmful effects on economic performance and threatens the objectives of promoting exports, substituting imports, and stimulating tourism. The result of this is the general perception that the convertible peso lacks sufficient support in terms of the production of goods and services, and for this reason it does not inspire confidence as a currency. The only argument that this perception can have are the difficulties of liquidity in attending financial obligations with suppliers, given the absence of official information with regard to the country's international monetary reserves and the real situation of balance of payments.

The lack of information with regard to the country's external financial situation is a phenomenon which affects the country's credibility in general and the government in particular. Cuba's statistical yearbooks have not published balance of payments details since 2005. From 2006 to 2008, only Current Account results have been reported. From that date there has been no information of the principal record of the country's international economic transactions.

Finally, measures aimed at the creation of opportunities for self-employment and the setting-up of agricultural markets have suffered several about-turns which have led to doubts about the commitment on the part of those who shape public policy with the reactivation of the market and the arrival of greater

economic freedom in the country. The activities authorized for self-employment cover manual labor or service activities which require little professional formation. This list excludes professional services which demand university or high-level technical formation in spite of the fact that 19.1 % of the working population has university-level education, and 51.7 % has medium-high or technical level (ONEI 2012a: Chart 7.7).

The prohibition of hiring labor has been lifted recently in an attempt to give more flexibility to the authorization for self-employment; however, considerable limitations continue to exist with regard to the type of work that can be carried out under these schemes.

On the other hand, there is no market for the raw materials and capital goods which are required to perform the functions which are permitted in the Ministry of Labor's resolution which regulates self-employment.

Finally, the tax system for self-employed work is not designed to stimulate this activity. People who rent out rooms or buildings must pay taxes, even though the premises are not occupied.

In this situation, there is no commitment by the government with regard to far-reaching economic reforms which would contemplate a legal framework which would endorse and guarantee private property and the operation of a regulated market.

## **The Necessary Reforms**

In recent years some government measures have been introduced with the intention of "updating" the Cuban economic model. This is not a case of a comprehensive economic reform, as was the case with China in the 1980s or Vietnam in the 1990s. However, in this author's opinion, the nature of the changes that would be necessary would go beyond the scope of an update, and require, as in the aforementioned cases, far-reaching economic reforms.

The most important measures to be adopted in recent years have been, among others, the reactivation of self-employed labor, the authorization of employees, authorization to buy and sell houses and automobiles, the possibility to have access to bank credits to build and/or renovate houses, as well as to pay for materials and labor costs for these purposes. Moreover, 3.4 million hectares have been rented out to 170,000 private farmers who are also authorized to sell their products directly to consumers and at tourist centers, and state apparatus has been reduced with the suppression of the Ministry of Sugar and its conversion into the entrepreneurial group "Azcuba."

The Government's announcement with regard to the reduction of the inflated payroll of State workers, has not had the scope it was originally reported to have, due to political implications, to the extent that it would go against one of the promises of the Cuban Revolution—that of full employment. At the end of 2011, it was

estimated that the number of self-employed workers would rise to 357,000, of which only 18 % would come from State organizations with whom they had ceased to be employed.

The experience of other reform processes in countries such as China or Vietnam suggests that Cuba's economic policy should be directed towards an extensive economic reform which would involve a systemic focus.

In this regard, three main strategic lines for debate are proposed for this reform, which could be focused in the following way: (1) reform of the working mechanism of the economy, (2) reform of the monetary system, and (3) new legislative framework which would establish clear and transparent norms, and institutionalize the market.

### ***Reform of the Working Mechanism of the Economy***

The reform of the working mechanism of the economy must be guided towards a greater use of the market as a mechanism for the assignation of resources under state control. The result of this would be a market regulated but not controlled by the State.

A series of rigidities still exists in internal markets, due to state controls.

Even though measures have been adopted in the way of allowing self-employment and to have other employees, we cannot talk of the existence of a real labor market in the country. The great majority of workers continue to be employed by the State, which fixes their salaries. In this way, the market plays no part in the determination of workers' salaries which, in most cases, are insufficient to satisfy their basic needs.

The capital market still does not operate in Cuba. Excessive state control with respect to foreign capital investment and the prohibitions which are in force at the moment for investment by Cuban residents abroad, limit the possibility of fresh capital arriving for the development of production and services. In practice, the excessive restrictions on the development of private enterprise have created a situation in which those who have greater possibilities of accumulating capital are those who are involved in illegal activities, and not the enterprising business people who abide by the law.

The limitations imposed on domestic private investment have produced an enormous contradiction in Cuban society, since the nonexistent or limited possibility of saving for investment has converted it into a consumer society, which is exactly the criticism leveled at capitalist societies. If the individual cannot save to invest, the only purpose that saving could have would be to increase future consumption, thus establishing consumption as the economic goal. This phenomenon ends up cutting off the business initiative and creativity of the individual and, consequently, that of society. In this situation, Cuban society has become an unsatisfied consumer society.

Some inflexible aspects exist in the goods market in spite of the liberalizing measures adopted in recent times.

Although its gradual elimination has been announced, the anachronistic system of regulated distribution (*libreta de abastecimiento*) still exists for products, and whose objective is to protect minimum levels of consumption of the low-income population. Regulated distribution of so-called “industrial products” (non-comestible consumer goods) disappeared with the crisis of the Special Period of the 1990s, and the regulated distribution of foodstuffs did not itself guarantee levels of nutrition for the healthy survival of the people. Apparently, for the purpose of human solidarity, an area of egalitarian distribution is maintained which, in all reality, does not allow people to lead a healthy life. All of this implies that, in practice, the day-to-day life of the great majority of Cuban people has become a struggle for survival.

As an alternative, it could be more efficient to carry out an adjustment of relative prices in accordance with market conditions and subsidize, at the same time, those people with low incomes whose living conditions would deteriorate with an adjustment of this type.

In the same way, the services market supports certain rigid aspects which lead to serious social contradictions. The prohibition of self-employed activities of certain professions which could offer professional services to society creates an inequality of opportunities of material progress which does not correspond neither to a contribution to society nor to social justice, least of all in difficult survival conditions. While certain categories of jobs may charge market prices, other professional categories pay these prices for services they receive, but cannot charge what there are worth because these services can only be carried out by state entities (accountants, economists, engineers, lawyers and other types of consultant, as well as doctors, nurses and teachers). Resolution 298 of 2011 of the Ministry of Finance and Prices refers to the payment of taxes for self-employed activities, and recognized 181 types of self-employed activities, among which is the “*repasadores*,” who are those who review students’ work out of class time but are not openly permitted to give proper classes, nor are active teachers allowed to work as “*repasadores*.”

In the liberalization of this market there would be an additional source of self-employed work which would contribute to the adjustment of the relative prices of services in accordance with market conditions. Without denying the importance of certain social services and Cuba’s achievement in offering these to all the population on an equal basis without direct payment, it should not be forgotten that no good or service can be distributed without first having been created, which implies that education and free health services, which are enjoyed by Cuban society, are the result of day-to-day efforts of millions of Cubans. Nevertheless, parallel to what the State can do in this area, it is possible that these services could be offered privately, provided that demand exists, and with adequate controls by the State.

One far-reaching reform of the working mechanism of the economy should include the express recognition by the country’s political authorities of the positive role that private property and enterprising business people could perform as agents of

economic growth and promoters of employment. In this environment, a law should be enacted to allow the creation of private companies, cooperatives and commercial company, with no restriction of the economic activity, scope or size of the company.

Another measure consistent with this idea is the liberalization of domestic markets.

The opening of the labor market should include the liberalization of salaries, regulated only by the setting of a minimum salary, and permitting the free movement of the workforce between geographical regions and sectors of the national economy.

The recent measure that permitted the buying and selling of housing should lead to the formation of a real-estate market and the possible creation of real estate companies, which would facilitate the development of the market. However, for this process to be effective, it would be indispensable for the financial sector to establish mechanisms for mortgage credit.

It is necessary to create conditions for the setting up of a capital market and along these lines it would be worth considering the convenience of facilitating access to the country of foreign private banks so that capital could be injected into the national economy, which is seriously affected by the lack of financial resources.

Current restrictions on foreign direct investment must be lifted. The process of authorizing the entry of foreign capital is time-consuming in terms of the processes involved, and depends on the discretion of the Government. The experience of China and Vietnam shows that direct investment, generated by its emigrants contributed substantially to economic growth. At the same time, it is necessary to open options for the entry of large stores which would lead to the development of retail trade, at present seriously affected by a persistent shortage of goods.

### *Reform of the Monetary System*

The Cuban monetary system suffers from three basic problems. The first of these is a dual system consisting of two different currencies with two different exchange rates which segment the market, financial operations and even accounting. The second is the multiple exchange rates which work for different types of transactions. Third, and not the least important, is that Cuban currencies lack sufficient support from the production of internationally tradable goods and services which presents them from being really convertible at international level.

The present dual monetary system,<sup>11</sup> based on the co-existence of two currencies, the Cuban peso, and the convertible Cuban peso, gave rise to an “emergent” sector

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<sup>11</sup> With the de-penalization of holding dollars and the authorization of their circulation in the domestic market, in 1993 (Decree Law 140 of 1993), a process of sui generis dollarization began, in which the North American currency circulated normally in one segment of the market for payment for the purchase of certain goods and services, while the national money circulated in another goods and services sector. In 2004 it was decided to replace the dollar with a convertible peso which was already in circulation as a token value of the dollar, and was its equivalent, firstly in transactions between companies and then in all the dollarized market segment.

which includes activities whose transactions are carried out in currencies or at prices which have references in convertible money. These are tourism, the majority of restaurants, as well as mixed companies and those with foreign capital, together with self-employed workers. At the same time, various State organizations have fixed prices for some of their services in “convertible pesos,” whose value is 25 times greater than the national currency, in which the country’s extremely salaried workers are paid, and at extremely low levels.

In the other market segment are all those activities which use the Cuban peso as a means of payment at prices controlled by the State.

The main economic problem caused by the dual currency is in maintaining certain “disconnections” between the “non convertible” segment and international prices. That segment continues to function with low prices and low salaries, fixed by the State. This situation prevents analysis to be made of the real economic efficiency of these activities in internationally comparable terms.

At the same time, from a social point of view, the dual monetary system has led to a deepening of the social divide, putting paid to the egalitarian argument of the Cuban government’s economic policy. The sectors of the population who receive salaries in convertible pesos<sup>12</sup> are economically better off than those who live exclusively from their salaries or retirement pensions in Cuban pesos.

The analysis of the problems of social inequality in Cuba during the period after 1959 has not been dealt with on the island, for essentially political reasons. There are no sufficiently substantiated or systemized scientific studies which enable analysis to be carried out of the long-term evolution of income distribution indicators.<sup>13</sup> Nonetheless, in recent years, evidence of the phenomena of social inequality and poverty has produced studies whose results are kept as “classified” information.

As a result of the dual currency and the selective authorizations for self-employed labor in certain types of production and services there has been an inversion of the social pyramid. In several studies carried out by social researchers in Cuba, it has been recognized that the income of self-employed workers is above that of state employees, in spite of the fact that in some cases the corresponding taxes have suffocated entrepreneurial initiative. Graduated, who are prohibited from carrying out their profession on their own account, earn less than many “start-up” entrepreneurs, even though during the past few years there have been salary increases in various professional categories, which have not essentially changed the social re-stratification which has occurred in Cuban society as a result of the economic crisis

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<sup>12</sup>The Cuban population can receive payment in convertible pesos (CUC) for remittances they obtain from their families abroad, tips for services in hotels and tourism, income which is supplementary to their salaries paid by foreign businesses, as a bonus payment, the so-called “stimuli” for certain workers in the official sector, income of workers hired temporarily to work abroad, and the income of self-employed workers.

<sup>13</sup>Añé (2007) mentions the increase in inequality, by means of the Gini coefficient based on the Economic Home Survey, which has increased from 0.25 in 1989, to 0.36 in 1996, and to 0.40 in 2006.



of the 1990s, the reformatory measures in general and in particular the dual monetary system and the corresponding market segmentation.

The dual currency has not served to overcome the disconnection between the domestic economy and the external economy, due to a nonconvertible national currency before the crisis of the 1990s. In reality, the convertible peso continues to be externally nonconvertible—it only has artificial domestic convertibility.

The currency generated by exports of goods and services are converted into national money at the official exchange rate fixed by the State, while the monetization of remittances as well as currency exchange operations with tourists and foreign visitors is based on the exchange rate fixed by the state.

It is only in that market segment, which operates with convertible pesos, that a certain relationship can be established between internal and external prices. Nevertheless, this relationship is distorted by state control over prices and the state monopoly over the retail trade distribution, even in the market which operates with convertible pesos.

The use of this type of official exchange rate at a level of parity between the US dollar and the Cuban peso in order to give value to exports and state imports does not permit an adequate relationship to exist between prices of exportable products and their production costs expressed in foreign currencies, due to the unreal nature of this type of exchange rate.

At the same time, goods and services which are not internationally tradable continue to be disconnected from the world market to the extent that their relative prices in local money are not comparable with similar products internationally, based on nominal exchange rates.

Finally, is the problem of the limited support of the national money which, in present conditions, constitutes the support of the whole monetary system which has broken its links with the gold standard.

As previously stated, there are no available statistics on the level of the country's monetary reserves. Nevertheless, the Cuban monetary system is a type of currency board in which the convertible peso maintains its exchange rate pegged to the US dollar at a parity of one to one, while the exchange rate of the convertible peso with respect to other currencies fluctuates, following the course of the US dollar against those currencies. In this way, the course of the convertible peso depends exclusively on that of the dollar without there being, in reality, any obligation by monetary authorities to issue convertible pesos supported by the dollar or other equivalent currencies in the international monetary reserves.

Xalma (2002), quoting Cuban economists resident on the island, states that dollarization and the use of a dual monetary system have been considered as a temporary, intermediate solution between the possibility of maintaining the clandestine circulation of the dollar, and the adoption of a national currency which is completely convertible, and which would require exchange unification by means of a strong devaluation. Both extremes are considered to be socially very costly.

Monetary duality has also implied exchange duality. On the one hand there is one official exchange rate, according to which one US dollar is equal to a Cuban peso, which is valid for international transactions, exports, imports, the

recording of monetary income payments, services, current transfers, and other international balance of payments transactions. This exchange rate, as has already been mentioned, has no relationship whatsoever with economic reality, and for this reason is an artificial rate. It does not express the relationship of relative prices between the two economies, nor does it reflect the parity of interest rates. In practice, this type of exchange rate overvalues the Cuban currency with a consequent negative effect on the competitiveness of its exports. Obviously, prices for Cuban exports in foreign currency have no direct relationship with the cost of production in national money or with the prices of these products in Cuban pesos, thus, a disconnection occurs between domestic economy and world economy, and the exchange rate loses its function as a link between both economies.

At the same time, a “market exchange rate” functions exclusively to change foreign currency that tourists or those who receive remittances put into the national economy, to acquire goods or services which are traded in the segment of the market which operates in currencies. This rate, which is apparently of the market, is in reality fixed by the State through its banks and exchange houses, which are the only entities authorized to carry out exchange transactions.

The Cuban monetary authorities recognize that the unification of the system is one of the unavoidable changes necessary to deal with the reconfiguration of the Cuban economic system. However, the technical and political complexities have led the country’s political hierarchy to postpone it for the time being.

The unification of the monetary system would necessarily depend on the specification of the type of monetary system the country could have. This would mean choosing between the option of a currency board based on a reference currency such as the dollar or in a currency basket, which could include currencies of the countries with which Cuba has commercial relationships, for example the Euro, Chinese Yuan, and the Canadian dollar.<sup>14</sup> This author would rule out the adoption of a foreign currency as the national currency (be it the dollar or the euro), due to the risks it would incur in the event that a country were to lack monetary sovereignty, in which case the State would lose the capacity of regulation through one of the most important instruments of economic policy.<sup>15</sup> In these circumstances the alternative of a currency board made up of a currency basket could be sufficient to ensure relative stability of the exchange rate for the compensatory effects that could result from the presence of difference currencies in the basket.

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<sup>14</sup> It would not make sense to include the Venezuelan bolivar as support for the Cuban monetary system, since it is not a sufficiently strong currency (in spite of its name as “bolivar fuerte”). Furthermore, there is strict exchange control on the part of that country’s government.

<sup>15</sup> One thing is when several countries voluntarily give up their monetary sovereignty to share it among others, as was the case with the euro, and another is when a country which lacks room for manoeuvre to influence the shared monetary policy of a monetary unión and must assimilate political decisions over which it has no control, which is the case with Panama, Ecuador and El Salvador, using the dollar as their currency, or Montenegro, which uses the euro in similar circumstances.

The experiences of the European crisis and the difficulties of weak economies such as that of Greece, in alleviating the crisis without devaluing its currency, highlight the problem of having no monetary sovereignty in a country which has obvious macroeconomic vulnerability.

On the other hand, in order to move towards a unified and convertible monetary system, it would be necessary to adjust the real relative value of the Cuban money with a firm economic grounding which would take into account the level of international monetary reserves as well as the material support of the currency in goods and services. This would imply adjusting salary and price levels into one currency which would reflect the reality of relative prices of the Cuban economy in comparison with international levels.

### ***New Legislative Framework Which Would Set Clear and Transparent Regulations and Institutionalize the Market***

Institutional reforms are a priority in a process which would lead to a reform of the economic system in Cuba. As Rodrik (2007: 222–223) states, countries which have a successful economic development are those who have managed to establish ... “systems of their own, with clearly defined laws, a regulatory apparatus which will curb the worst kinds of fraud, anti-competitive behavior and moral risk; a moderately cohesive society which shows evidence of trust and social cooperation; political and social institutions which mitigate risk and deal with social conflict; a rule of law and a clean government...”. It is clear that Cuba does not comply with all the aforementioned elements.

Excessive state control is based on a complex system of monopolies which generate their own inefficiencies, give explanations of economic theory, and limit the competitive environment. Property rights are not adequately guaranteed by the country’s legislative framework. The regulatory framework is characterized by allowing what can be done and not by prohibiting that which cannot be done, and at the same time suffers from legal vacuums which give rise to the loopholes which are found necessary to intervene opportunistically in processes.

In this environment, the urgency of institutional reforms is crucial. As topics for debate, the following ideas are put forward here, with some of the measures which could make a contribution to the creation of a legislative framework which would lead to positive changes in the economic system.

In the first instance, the institutions which the current Constitution recognizes as powers of the State would be strengthened. The National Assembly should fulfill a new role and properly comply with its function as “the supreme organ of power of the State.” For this to happen, it would be necessary for its sessions to really produce intensive legislative activity, and not unanimously to approve projects of law which are in process. Parliament is required to show more legislative initiative and not be simply an immense body in which decisions which have already been taken by the executive powers are processed or endorsed.

It is also necessary that the judicial organs, and those of arbitration, are State entities which are really independent of the Government. This would guarantee the necessary transparency in the administration of justice in legal processes in which the State and private individuals, or individuals between themselves, are involved.

If it is accepted that private property can be a factor which contributes to social and economic development, this must be endorsed as an amendment to the Constitution, to the extent that it will guarantee private property under law, in this way establishing the supremacy of social interests in the event of serious conflicts between private and social interests.

At the same time, Cuba needs a new body of laws which will control economic activity and establish clear and transparent rules which will require the markets to function in a proper way.

Also necessary is a new Commercial Code which recognizes the new types of companies with different types of property and methods of business association, create conditions for the appearance of new types of mercantile companies and regulate the conditions under which differences between companies themselves, or with the State can be resolved. This new code could be complemented by a company law, which, in the case of Vietnam, regulates the establishment, management, and the organization of different types of company.

A new Labor Code should clearly establish the rights and duties of workers and their forms of free association to protect their social interests, as well as the rights and duties of workers and their employers. The new code should liberalize the labor market, permit the free movement of workers between regions and types of activity, the free fixing, with market criteria, of salary levels, and the abolition of present practices under which those who work for mixed capital companies must be hired by the State, and receive a low salary fixed by the latter, in spite of the fact that the State charges foreigners on a much higher salary scale in foreign currency, keeping for itself a substantial surplus.

A new law in the tax system should set out mechanisms for the broadening of the taxpayer base in society, not to sustain an overgrown bureaucracy, but to ensure sustainable conditions for an expansive social policy. The system should preferably be progressive, so that contributions are related to real income levels of the population, and should include a set of taxes that exist in the majority of countries, such as income tax, sales tax, inheritance tax, stamp duty, among others.

A new monetary law should set out mechanisms for, and define, a unified monetary system which will guarantee the existence of a monetary unit that will really comply with the functions of money and which can be used in any economic transaction in the country.

A new banking law will enable foreign banking institutions to be established. This will facilitate a marked development of bank credit, especially that of consumer credit and private investment. This law would embrace sufficient supervisory mechanisms to offer the regulations necessary to avoid financial crises.

A new housing law to correct the present contradictions between the existing Law 65, the General Housing Law, and the measures which Decree 288 have amended the General Law. The new housing law should allow for the existence of a

real estate market which would allow real estate agencies, through their specialized activity, to contribute to the swiftness of sale and purchase processes.

A new foreign investment law could give flexibility to the mechanisms for accessing productive investment not only of foreign capital, but of Cubans resident overseas who could be interested in contributing to economic growth in a new business environment which offered the necessary guarantees.

The adoption of an economic reform aimed towards the market, a new legislative framework with clear and transparent regulations and a unified convertible monetary system are essential elements, but are not sufficient to relaunch the process of economic development and international insertion of the country. They must be complementary, with an economic policy which will induce far-reaching structural changes which will set the country on the road to progress.

## Final Remarks

The Cuban economy and society find themselves at a decisive moment in which change has become an urgent necessity. Until now, the Cuban political leadership has defined changes as a updating of the “Cuban socialist model,” aimed towards greater productive efficiency.

However, the “updating” of the model may not be sufficient to produce the changes which would be necessary to achieve a significant improvement in the standard of living of the Cuban people and the beginning of a process which will lead the country along a path of greater economic and social development.

More than a question of semantics, the important consideration is the character and scope of the measures to be adopted. This work does not pretend to be the final analysis on the subject, but to form part of a serious academic, political, and unprejudiced debate from which new ideas will no doubt be forthcoming, in the interests of fostering economic development, improvement of the standard of living, and the modernization of the country.

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# Chapter 5

## Monetary and Exchange Rate Reform in Cuba: Lessons from Vietnam

Pavel Vidal

### Introduction

In 2010 it was confirmed that the Cuban economy was beginning a new economic reform, officially labeled an “update of the economic model.” At the end of 2010, the “Guidelines for Economic and Social Policy” (Guidelines), was issued, a text that to some extent explains the content of the reform for the period 2011–2015.<sup>1</sup> The Guidelines have a section on monetary and exchange rate policy that outlines the changes intended for that field. The proposed changes could be grouped into three directions or main goals: (1) currency unification between the Cuban peso and the convertible peso (CUC), (2) improving the strategy for monetary policy, and (3) financial transformations. This paper seeks to evaluate these three objectives given Cuba’s current situation following the monetary and exchange rate policy transformations of the 1990s and subsequent setbacks, while using Vietnam as a case for comparison.

In order to assess the available content of the Cuban monetary and exchange rate reform and obtain lessons from international experience, some stylized facts from the Vietnamese reform since 1986 (Doi Moi) are taken as points of comparison. The Cuban government itself has been referring to the Vietnamese experience, but specific aspects are pinpointed without asserting that the Cuban Guidelines are following this model. As a matter of fact, reading the Guidelines and observing the early measures of Raul Castro’s government, we cannot infer that the Cuban government

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I would like to extend my sincere gratitude to Institute of Developing Economies IDE/JETRO for making possible this research in Japan from May 6, 2011 to August 6, 2011.

<sup>1</sup> The document can be read in Spanish at the Granma Web site (2011).

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is considering an immediate transition to market socialism in the Vietnamese or Chinese style, nor is it a transition process to capitalism as followed in the former socialist countries in Europe.

The structure of the paper is as follows. Section “Comparison with Vietnam” compares some general characteristics of the starting point for reforms in Cuba and Vietnam in order to aid comprehension of the overall framework. Section “Inflation, Liberalization and Adjustment” examines inflation and its potential connections with the liberalization and adjustment process. In sections “Currency Unification,” “Improving Monetary Policy Strategy,” and “Financial Transformations,” the three previously mentioned objectives of the monetary and exchange rate reform are evaluated. Section “Conclusion” presents the concluding remarks.

## Comparison with Vietnam

The starting point of the Cuban reform has many differences when compared to Vietnam, and some similarities. Table 5.1 condenses the main characteristics of the initial conditions for the reform.

The first rows show that three of the major differences are in size, demographics and natural-resource endowments. It is not efficient for Cuba to try to replicate a model of agricultural growth with a mainly urban and aging population, and after investing substantial resources in education for decades. The urban population in Cuba represents more than 75 % of the total; whereas in Vietnam it represented 18.8 % in 1975 and 26.4 % in 2005 (UNDP 2008). The proportion of the population aged 65 and above is more than 12 % of the total in Cuba, while in Vietnam it is much lower: 4.6 % in 1986 and 6.3 % in 2008 (World Bank, various years).

The transformations in Cuban agriculture are important at the beginning of the reform, since 40 % of land is idle, and the dependency on food imports is between 60 and 80 %. This situation is deteriorating due to the escalation of international food prices.<sup>2</sup> There is also significant popular dissatisfaction regarding food consumption. However, it is highly unlikely that Cuba can have the same response to the liberalization of the agricultural sector and its impact on economic growth as Vietnam did, mainly due to the dissimilar demographic conditions and because Cuban agricultural production accounts for only 4 % of GDP while Vietnamese agricultural production accounted for 40 % of GDP in 1987.

Vietnam had a windfall in the form of oil revenue at the time of the reform. International firms are drilling in Cuban waters in the Gulf of Mexico but there is no confirmed positive result so far. Cuba still depends on the import of oil from Venezuela. Another advantage for Vietnam has been its location in a more dynamic region. One similarity is that both countries were subject to the American embargo at the time of the reform; only in 1994 was the American embargo on Vietnam lifted.

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<sup>2</sup> An evaluation of Cuban agriculture can be found in Nova (2010).



**Table 5.1** Cuba and Vietnam: reform starting conditions

Characteristic	Vietnam	Cuba
Population size	86.1 million	11.2 million
Demographics	Young and rural population	Aging and urban population
Natural resources	0	x
Oil	0	x
Region	Asia (dynamic)	America (dynamic?)
US embargo	0	0
Soviet-style system	0	0
State sector size	Smaller	Big
Recent past of capitalism	0	x
Timing	0	x
Education	x	0
Health	x	0
Infrastructure	x	0
Overseas community	0	0

*Note:* “x” indicates absence or no significant presence compared to the other country. “0” indicates presence or relative abundance when compared to the other country

*Source:* Author

However, there is significant benefit in the comparison with Vietnam based on the similarities between the problems Cuba is currently facing and those faced by Vietnam beginning in 1986, when the country launched the Doi Moi reform, since both starting models share many characteristics of the Soviet-style system. In addition, the two processes have attempted to focus on changes in the economic sphere while maintaining the essence of the political system alongside a willingness to undertake gradual, possibly stable, reform of the bureaucratic command model.

The most critical disadvantages that Cuban leaders have to overcome compared to the Vietnamese are the large size of the state sector, the absence of recent experiences of capitalism, and that this is perhaps not the best timing for Cuban revolutionary leaders to transform the economy—after several decades of avoiding recognition of the structural problems of the model and the necessity for dramatic shifts. One pessimistic view is that the current reform is too little, too late.

The state sector in Vietnam was smaller than in any other reforming socialist economies. Large-scale state enterprises formed only a small part of its economy. In Cuba, and also in Eastern Europe, the share of large-scale industries and state enterprises was far higher. Dollar (1993), Perkins (1993) and Riedel and Comer (1995) agree that the structure of the Vietnamese economy was convenient for responding to “big bang” liberalization. It is easier to make a market system work when small units are in the majority. Farmers, household businesses, and small industries can adjust their method of operation to market forces much more easily; they are natural net-income maximizers. They have less to learn when the overall economic system converts to market principles, while big industries need more time. Therefore, the Vietnamese economy was in a better position to respond to the incentives provided by the market-oriented reform than is the current dominant state sector in Cuba. In principle, this suggests that the reform should be more gradual in Cuba than it was in Vietnam.

In Cuba, government expenditure accounted for 34.7 % of GDP in 2008, whereas in Vietnam it accounted for 7.8 % in 1989 and 6.1 % in 2008. With a big state sector, there is more room in Cuba for rent-seeking behavior and resistance from the bureaucratic sector. It is also more difficult to implement institutional reforms and change people's minds after 50 years of living under consistent rules and ideology opposed to the market and private sector.<sup>3</sup> On the contrary, Vietnam had a recent past of capitalism in the southern half of the country, and was therefore better prepared to adjust to market reforms.

Vietnam initiated its reform before the USSR collapsed; the country even used Soviet aid to support part of the early costs and adjustments of the reform (Dollar 1993; Perkins 1993). Vietnamese GDP did not decrease after the collapse of the USSR thanks to the early reform, while the Cuban GDP dropped by 35 % in the 1990–1993 period. Cuba began a reform in the 1990s, but this was halted a few years later. Real salaries in the Cuban state sector and the overall standard of living have never recovered completely following the demise of the USSR. At present, most Cubans are skeptical about the capacity of their own government to achieve an efficient and productive economy and increase their standard of living. Raul Castro is 80 years old and there is no visible new generation of leaders. The current leaders are at a crossroads, since they want to implement gradual reform, but are running out of time. Obviously, this is not the best timing for the reform.

When compared to Vietnam, Cuba's major strength at the initiation of its reform appears to be the higher level of social development. Vietnam does not have bad indicators; in fact, the Human Development Index classifies it within the countries with *medium human development*, ranking 105 with a positive trend for the index of 0.590 in 1985 to 0.733 in 2005. However, Cuba's social indicators are superior. The country ranks 51, with a Human Development Index of 0.838, placing it among countries classified as having *high human development* (UNDP 2008).<sup>4</sup>

It is also understandable that Cuba has better infrastructure than Vietnam at the inception of Doi Moi, given that Vietnam was just recovering from a painful and costly war. Even today Cuba has a number of better infrastructure indicators. Nevertheless, Vietnam has been investing in infrastructure with the help of FDI and foreign aid, and it is likely to surpass Cuba in some areas, such as telecommunications.

Finally, both countries have strong overseas communities. The Vietnamese government has promoted constructive links between overseas Vietnamese and the home country since the early stage of the reform. For Cuba this seems to be much more complex, but certainly not impossible.<sup>5</sup>

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<sup>3</sup>Internal (and external) resistance to the Cuban reform is evaluated in Alonso et al. (2011).

<sup>4</sup>Mesa-Lago (2000, 2005) and Espina (2008a, b) examine the achievements and challenges of social policy in Cuba.

<sup>5</sup>Domínguez et al. (2011) debate this option in a Cuban Catholic Church magazine.

## Inflation, Liberalization, and Adjustment

Before the partial reforms of the 1990s, the Cuban family's basic consumption basket was obtained almost entirely from state retail networks. In this environment, monetary disequilibrium was not reflected in prices; rather, it was apparent in the accumulation of excess liquidity. Since the 1990s, inflationary processes and exchange imbalances in the Cuban economy have emerged not only in the informal market, but also in the formal consumption markets and currency exchange agency (Cadeca), which was introduced during those years. This was reflected in the monetary policy strategy, which was increasingly less concerned with the appearance of phenomena such as excess liquidity and repressed inflation, and more focused on price and exchange rate stability (Vidal 2012b). This goal is now reinforced in the text of the Guidelines:

To manage monetary policy to regulate the amount of money in circulation and credit levels, based on the requirements and tools of the plan, in order to facilitate monetary and exchange rate stability, as well as the orderly development of the economy.

After high inflation at the beginning of the 1990s, the economic authorities were able to stabilize prices. The variation in the consumer price index (CPI) in Cuban pesos has never been more than one digit since 1994. Inflation remained low throughout the first decade of this century.

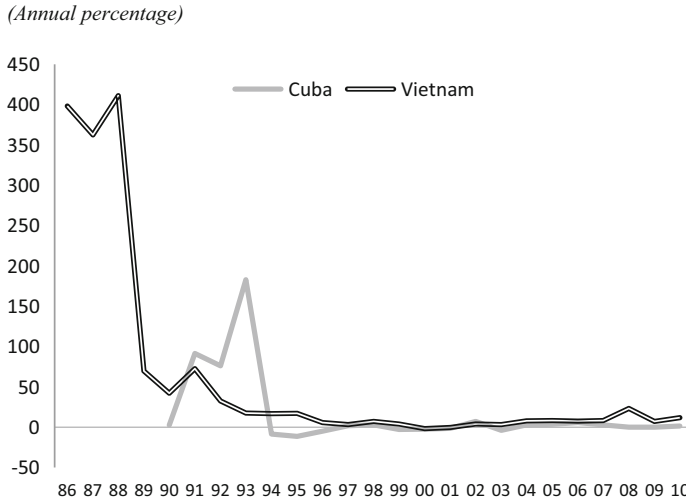
The low inflation since 1994 has several fundamental determinants. First, Cuba has maintained an average low fiscal deficit. With no domestic market for public debt, the fiscal deficit is monetized by the Central Bank. Thus, fiscal equilibrium immediately helps to regulate the growth of the money supply and hence inflation. Second is the policy of fixed exchange rates on both the Cuban peso and the convertible peso, and third is direct government control over state salaries and some prices (Vidal 2012b).

Low inflation is an important advantage of the current Cuban reform compared to the reform of the early 1990s, as well as compared to Vietnam (see Fig. 5.1).

In Vietnam before 1986, the inflation rate fluctuated within the range of 50–90 %. The liberalization process since 1986 led to higher inflation. The annual inflation rate rose above 350 % in 1986–1988 (see Fig. 5.1). The main sources of inflation were: (1) the price shift from officially set prices to market prices, (2) a larger fiscal deficit: In moving to a market system, subsidies to state enterprises increased while fiscal revenue fell since a new tax system requires a longer time for implementation, and (3) *pass-through* from the exchange rate devaluation to retail prices (Dollar 1993; Riedel and Comer 1995).

Vietnam has instituted a comprehensive disinflation program since the late 1980s (Dollar 1993; Riedel and Comer 1995; Vo Tri et al. 2000). In 1989 the government started to bring prices under control (see Fig. 5.1). The main stabilization measures were:

1. A real rise in interest rates that caused a strong portfolio adjustment by households in favor of bank accounts in dong rather than dollars and gold.

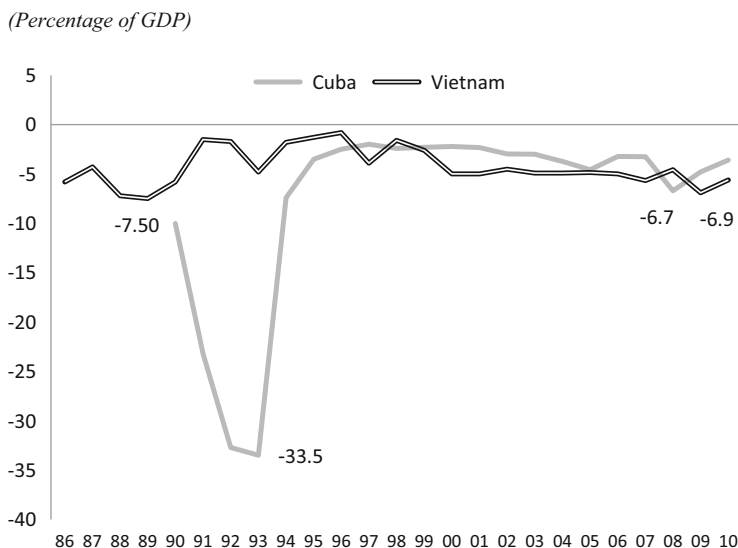


**Fig. 5.1** Cuba and Vietnam: Inflation rates, 1986–2010 (annual percentage). *Source:* Author, on the basis of data from ONE (various years) and World Bank (various years)

2. Fiscal restraints that cut subsidies to state enterprises, postponed investments, and demobilized half a million soldiers. Since 1992 oil revenue and the inflow of FDI has also helped to reduce the fiscal deficit.
3. Labor adjustment in the state sector, first from 4.1 million in 1988 to 3.5 million in 1990 (600,000 in 2 years), and by 1992 up to 800,000 workers, 33 % of the state labor force. Most of this adjustment was in state-enterprise employment rather than in the civil service. In this period the number of SOEs declined from 12,000 to 7,000. Unemployment was mainly absorbed by the household business sector.

Even though low inflation is an advantage of the current Cuban reform, the ongoing liberalization process could put price stability at risk. Like Vietnam, Cuba will experience inflationary pressures resulting from the unavoidable exchange rate devaluation (see “Currency Unification”). Inflation may also arise because of price adjustments from officially set prices to market prices, the phasing-out of the ration card, the changing of the system of subsidies, an increase in the non-state sector, the emergence of markets for houses and cars, and an expansion of bank credit for consumption and private business expansion, among other eventual market-oriented changes. Another potential source of inflation would be the impact of some of those same measures on the fiscal deficit.

The fiscal deficit in Vietnam during the Doi Moi reform was never close to the Cuban records of the early 1990s. The highest deficit recorded in Vietnam was 7.5 % of GDP in 1989, while Cuba surpassed 30 % of GDP in 1992 and 1993. In the 2000s Cuba had an average fiscal deficit lower than Vietnam with a peak in 2008 (6.7 %); the Vietnamese peak was 6.9 % in 2009 (see Fig. 5.2).



**Fig. 5.2** Cuba and Vietnam: Fiscal deficit, 1986–2010 (percentage of GDP). *Source:* Author, on the basis of data from ONE (various years), Ministry of Finance of Vietnam ([www.mof.gov.vn](http://www.mof.gov.vn)), Riedel and Comer (1995), and Chu Thi Trung and Dickie (2006)

Price stability in Cuba may continue to be supported by the strategy underlying the reform—the Guidelines apparently plan the timing of the fiscal and labor adjustment for before the macroeconomic imbalances emerge. The authorities are attempting to implement the adjustment of government expenses and taxes parallel to the liberalization of markets. The size of the state sector is being reduced, fiscal expenditures are dropping, and a new tax system is being put in place. The plan for 2011–2015 is to reduce employment in SOEs and government institutions by 1.3 million workers, which in absolute terms is similar to the Vietnamese labor adjustment and, in relative terms, accounts for 20 % of the state labor force. The Cuban government also wishes to see the unemployment absorbed by the household business sector and agriculture, similar to Vietnam.

As shown in Fig. 5.2, the economic adjustment has allowed the Cuban authorities to reduce the fiscal deficit from 6.7 % of GDP in 2008 to 4.3 % in 2009 and 3.6 % in 2010. An adjustment also took place in the area of foreign trade. In 2009, a severe import cut (–37.3 %) was implemented, thereby allowing for the emergence of a US\$2,038 million surplus in the foreign trade balance of goods and services. The import reduction policy continued in 2010, albeit less severely; imports fell 3.3 %. The last public data available reported 125,000 state workers laid off, while 180,000 new private self-employed workers and microenterprises registered during 2011.

If the Cuban government is able to implement the planned labor adjustment together with the opening of the non-state sector and the maintenance of fiscal equilibrium, then the risk of high inflation will certainly be lower. The question that

arises is whether it is efficient to support new employment with the opening focused only on microenterprises and agriculture, without taking advantage of the enormous amount of resources invested in education. It would seem far better for sustainable economic growth based on productivity gains to extend liberalization to a non-state sector of a larger scale, including a renewed aperture to foreign direct investment (FDI) beyond the small group of joint ventures that already reside on the island.

## Currency Unification

The dual currency in Cuba began as a process of dollarization in the 1990s, and was linked to the economic crisis, imbalances, high inflation and the resulting mistrust of the Cuban peso. Dollarization was only partial, the Cuban peso continued to be used in many areas of the economy, such as salaries, retail markets, savings accounts, and agriculture transactions, among others. After approximately 10 years, in 2003 and 2004, a package of measures was implemented that led to the replacement of the dollar functions by a third currency, the convertible peso. Today the economy is no longer dollarized, but maintains the parallel circulation of two currencies, both domestic—the Cuban peso (CUP) and the convertible peso (CUC).<sup>6</sup>

During the 1990s, along with the dual currency system, a much more distorting factor was introduced; the dual exchange rate. The exchange rate of the Cuban peso in the informal market suffered a massive devaluation against the dollar in 1990–1993. This devaluation of the Cuban peso was later assumed by the state foreign exchange agency network (Cadeca) which carries out transactions only with the household sector. However, the devaluation was never factored into the accounting, financing or trade operations of the SOEs or joint venture companies. Even today, the exchange rate of the Cuban peso in the entrepreneurial system maintains the value it had during the 1980s.

The exchange rate duplicity of the Cuban peso is the main factor that has complicated the removal of the double currency system in the Cuban economy. For the household sector the exchange rate is 24CUP/CUC (through Cadeca), while for the business sector (SOEs, joint venture companies and also government institutions) the exchange rate is 1CUP/CUC.<sup>7</sup> Therefore, the Central Bank's main measure for currency unification will need to be the devaluation of the Cuban peso in the business sector.<sup>8</sup>

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<sup>6</sup> See Vidal (2012a) for more details on monetary duality in Cuba.

<sup>7</sup> The exchange rate for the convertible peso vs. the US dollar is 1CUC/USD. The indirect exchange rates for the Cuban peso are therefore 24CUP/USD for the household sector and 1CUP/USD for the business sector. The Central Bank of Cuba has followed a fixed exchange rate policy for both domestic currencies, with exchange control in the business sector. Companies and institutions are prohibited from going to the currency exchange agency (Cadeca) to arbitrage exchange differences, which in itself is difficult since Cadeca deals only in small cash transactions.

<sup>8</sup> In addition, devaluation of the CUC against the USD (i.e., devaluing the rate 1CUC/USD) will be helpful for exchange rate equilibrium and export promotion.

The currency and exchange rate duality has huge costs for the entrepreneurial system. The excessively overvalued exchange rate of 1CUP/CUC (1CUP/USD) distorts economic measurement and decisions made by enterprises, at the fiscal level, and as part of central planning. The excessive value of the Cuban peso conceals subsidies as well as an artificially profitable group of companies on the one hand and a deceptively unprofitable group (especially exporters) on the other. The Guidelines talk of closing the steadily unprofitable SOEs, substituting imports and eliminating subsidies, but in reality, they cannot make sound decisions in this direction cannot be made by measuring costs using the 1CUP/CUC exchange rate. The overvaluation of the Cuban peso exchange rate has prevented its free convertibility for the business system, which discourages foreign investment, causes absurd segmentation, and constrains value chains, thus weakening the economy.

One might expect that the final objective of the elimination of the dual monetary system is the restoration of the Cuban peso as the sole monetary unit. The government's preference for the Cuban peso lies in several factors: (1) it is the historical currency; (2) most Cuban savings accounts are in pesos, and the population has confidence in this currency, which is reinforced by the popular expectation that the Cuban peso will again become the only circulating currency<sup>9</sup>; (3) salaries are in pesos; paying the equivalent in convertible pesos would be further evidence of the low level of real wages in the state sector. This does not have an economic effect, but its political and psychological impacts are an effective toll on the people; (4) national accounts, the fiscal budget and key sectors such as agriculture operate in Cuban pesos.

Nevertheless, the Cuban Reform Guidelines do not say very much, just this paragraph on dual currency:

Move toward monetary unification in a process that depends mainly on increases in labor productivity, the effectiveness of distributive and redistributive mechanisms, and thus availability of goods and services. Due to the complexity of monetary unification, it will require careful preparation and execution, both on the objective and subjective level.

The paragraph on dual currency addresses preparation on the subjective level since, popularly, the dual currency tends to be associated with the low purchasing power of wages and inequality. Cubans still regard the economy of the 1980s with the Cuban peso as an ideal, and many expect to recover that status once all prices and incomes return to that currency. It is forgotten, however, that this status depended on Soviet subsidies and that a severe adjustment and revision of the model is now required to boost productivity as the only way to increase wages.

The Guidelines are enigmatic on many additional issues of exchange rate policy; the speed of the process of convergence in the exchange rates, whether or not the market will play a role in determining the equilibrium exchange rate, how convertibility for the Cuban peso will be applied in the business sector, and whether or not to follow the international trend toward more flexible exchange rate regimes.

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<sup>9</sup>In 2009 the savings accounts of the population in the Cuban SOCBs had the following composition: 59.2 % in CUP, 37.6 % in CUC and 3.1 % in USD (Pérez 2011).

In the 1980s, Vietnam also had two official exchange rates that were excessively overvalued. In late 1987, the exchange rates were VND225/USD and VND368/USD, both far below the market level. The response of the Vietnamese authorities to this situation was sudden devaluation of the dong by more than ten times. This is the so-called *big bang* approach applied to exchange rate reform. In 1989, Vietnam had a single exchange rate close to the market level (VND4,500/USD). Devaluation of the nominal exchange rate caused inflation, not a devaluation of the real exchange rate (Vo Tri et al. 2000).

It is not possible to know for sure the path chosen by Cuba's economic authorities for currency unification. In the rationale of the still centrally planned management of the economy, the authorities could choose gradualism in the form of a planned process of slow devaluation of the Cuban peso in the entrepreneurial system, with the possibility of differences between sectors and other arrangements as a tonic for making changes at the margins. Decisions will have to be made on whether to maintain controls on prices and manage the process of *pass-through* administratively, or allow it to undergo autonomous adjustment in wholesale and retail prices.<sup>10</sup> At the same time, compensatory measures will be needed to mitigate the impact of devaluations on the currency-mismatched balance sheets of SOEs and SOCBs, at least for a reasonable period.

The large gap between exchange rates in Cuba (2,300 %) supports a case against a sudden devaluation of that magnitude, but also against the other extreme alternative of a too-slow adjustment that would require another 20 years of bearing the costs of monetary duality.

It seems that the exchange rate devaluation should be more gradual in Cuba than in Vietnam because the high proportion of medium and large SOEs in the economy makes it less prepared to respond to exchange rate incentives. As mentioned earlier, the state sector in Vietnam was smaller than in any other socialist country. Farmers, household businesses and small industries were in a better position to respond to a monetary reform and adjust their balances and operations to a new exchange rate.

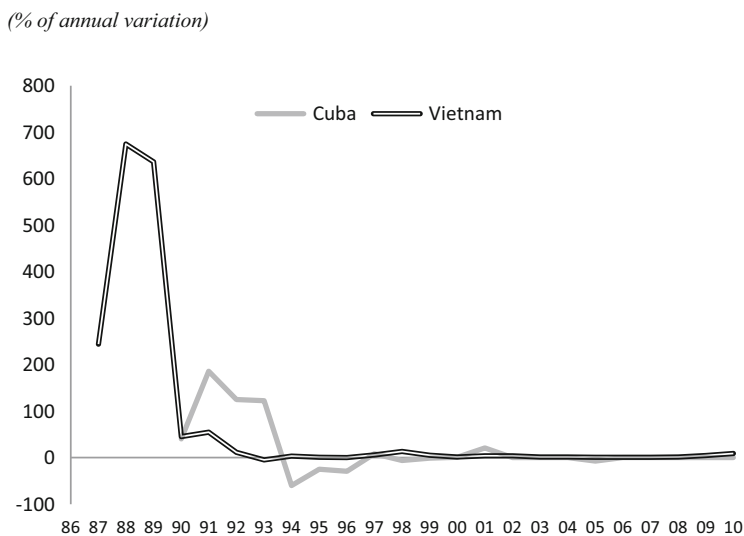
Devaluation of the real exchange rate in Vietnam was very important for the export-led growth strategy. The devaluation of the real exchange rate had a positive impact on the balance of payments, but this was because it occurred together with increasing flexibility in foreign trade, something that is not clear in the Cuba reform. Exports responded in Vietnam with a 25 % annual growth rate in 1989–1993, but this was because the devaluation occurred together with the elimination of the state monopoly on trade, and access by exporters to imported capital goods and intermediate inputs (Dollar 1993; Riedel and Comer 1995).

Another point is that Vietnam did not receive loans from the IMF or World Bank to make its exchange rate adjustment (the American embargo was still in force at the time). Since they initiated the currency reform before the Soviet Union collapsed,

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<sup>10</sup>Hernández (2011) estimates a response of 50 % of the CPI in Cuban pesos to a shock of 100 % in Cadecca's exchange rate (household sector). However there is no such estimation for the *pass-through* for the official exchange rate of the Cuban peso in the business sector or in the markets in CUC, which is expected to be much higher, since they are more connected to external trade.





**Fig. 5.3** Cuba and Vietnam: Exchange rate evolution, 1987–2010 (% of annual variation). *Source:* Author, on the basis of data from Cadeca and the [World Bank \(various years\)](#)

they still had some aid from the USSR to compensate against negative effects of the exchange rate devaluation. Cuba is not a member of any major international financial institution and is undergoing a domestic financial crisis. Therefore, it will have to implement the devaluation with scarce resources for compensation measures.

In sum, Cuba's exchange rate adjustment in the 1990s was smaller than that implemented by Vietnam during its monetary reform in the 1980s (see Fig. 5.3) and it was incomplete since it only took place in the household sector. To eliminate the monetary duality, the Cuban authorities must extend the devaluation of the Cuban peso to the SOEs, joint venture companies and government institutions. They have to decide whether to do it gradually, use a “big bang” approach as in Vietnam, or an intermediate strategy, if possible. It is also important to combine the monetary adjustment with a more comprehensive liberalization process in order to better prepare the economy to respond to the exchange rate devaluation.

## Improving Monetary Policy Strategy

Although since the 1990s the Central Bank of Cuba has sought to avoid high inflation, it has not defined an explicit inflation target. Monetary policy has succeeded in keeping inflation low. However, the CPI data in Cuban pesos shows some degree of volatility, which in some cases alternates with deflationary trends. This is the result of a monetary policy with a discretionary approach, which tends to adjust past imbalances and is managed in an extremely difficult context of two currencies and

multiple exchange rates. The following Guideline proposal should be understood in this sense:

To structure a proper approach to monetary planning in the short-, medium-, and long-term, we aim to achieve external and internal monetary equilibrium, not in a precise way, but as a whole.

The paragraph also reflects the fact that the dual currency system and certain aspects of monetary policy have not facilitated the best way to articulate the internal balance and the objectives for external balance.

For example, coordination of policies for achieving internal balance and price stability has been favored by the GASFI (Internal Finance Analysis Group), in which officials from the Ministry of Economy and Planning, Ministry of Finance and Prices, Ministry of Domestic Trade and the Central Bank, regularly gather in order to plan each institution's actions for maintaining monetary and fiscal balance. However, the same coordination and well-structured policy design approach to ensure consistency between internal and external balances does not exist.<sup>11</sup>

This lack of coordination between internal and external equilibrium did not help the management of monetary policy after de-dollarization. The most obvious evidence is the currency crisis in late 2008. The CUC, the currency that replaced the US dollar in 2003–2004, has suffered a convertibility crisis since 2008. Cuban banks were forced to freeze foreign payments from checking accounts in CUC due to the scarcity of foreign exchange reserves to maintain its convertibility.<sup>12</sup>

After de-dollarization, the *currency board*, which regulated the issuance of convertible pesos, was broken up. The issuance of Cuban pesos is restricted by an institutional arrangement whereby the Central Bank cannot monetize a fiscal deficit above that approved by the National Assembly each year. However, there is no similar arrangement for the convertible peso. After the breakup of the *currency board*, monetary policy was freed to print unlimited CUCs. The absence of rules, among other factors, ended up producing an excess issuance of this currency.

Apparently, part of the reform seeks to correct this discretionary monetary policy design, as seen in the following paragraph of the Guidelines:

To establish appropriate rules for monetary issuances and the use of timely indicators to manage them.

Two absences in the text are the terms transparency and autonomy. It is very difficult to think of the success of a rule that is not transparent and cannot be publicly audited. Autonomy, at least instrumental, is essential for the implementation of

<sup>11</sup> For an analysis of GASFI and coordination in Cuban monetary policy, see Pérez (2011).

<sup>12</sup> Vidal and Gonzalez-Corso (2010) determined that the principal causes of the Cuban banking and currency crisis since 2008 have been: (1) the de-dollarization process initiated in 2003, which was implemented without the establishment of transparent rules to regulate the expansion of the convertible peso's monetary base, (2) the centralization of foreign exchange transactions in the *Unique State Hard Currency Income Account*, which contributed to the disproportionate concentration of financial risk in the hands of a single economic agent: the central government, (3) the deterioration of the country's macroeconomic indicators since 2008, and (4) the fixed exchange rate policy.

monetary policy based on technical criteria. At the same time, macroeconomic coordination can harmonize the policies that determine medium- and long-term equilibrium trends, including the plan in the case of a planned economy such as that of Cuba.

It is important to note that in these areas Vietnam has not achieved the best progress. The institutional framework for Vietnamese monetary policy is based on an arrangement in which the National Assembly decides the annual inflation target and monetary policy strategy, and then monitors implementation. In terms of objectives, Vietnam publicly defines its final annual inflation objective, as well as midterm targets for annual growth of M2, credit and dong devaluation, all consistent with the macroeconomic goals of the 5-year plan. The nominal anchor rests mainly on the annually controlled dong devaluation, even as in recent years this has lost credibility. Despite all the institutional shortcomings of Vietnamese monetary policy, it is much clearer and is designed with a greater degree of public information than the Cuban policy.

The other aspect of monetary policy strategy mentioned by the Guidelines is the tools:

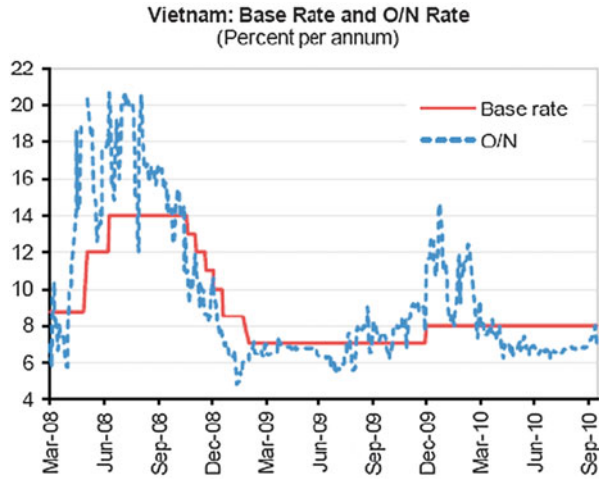
... to promote the use of monetary policy instruments—such as administrative control of credit, mandatory deposits from commercial banks at the central bank, the regulation of interest rates and lending to financial institutions—in order to manage circumstantial monetary disequilibrium. For the population sector, the correlation between the growth of money and the retail trade, and managing this relationship in a planned medium term, will remain the key instrument for achieving monetary and exchange stability in this sector...

The quoted paragraphs emphasize the use of instruments for the direct control of interest rates and credit, in addition to the retail trade. The latter refers to the sale of retail goods and services in the state stores network, which is used to regulate demand in non-state markets and demand for foreign currency in the exchange agency Cadeca, and thus to influence price stability and exchange equilibrium (see Pérez 2011; Vidal 2012b).

In the Vietnamese case, by comparison, there has been a disengagement from direct instruments of monetary policy to focus on conventional indirect tools such as open market operations, legal reserve requirements and the discount rate. The State Bank of Vietnam has followed an international trend in guiding monetary policy actions through an interbank basic interest rate as an operational target (Fig. 5.4) that exerts its influence through auctions of government bonds and using interest rates for deposits and loans of commercial banks with the central bank (Vo Tri et al. 2000).

In this regard, one final lesson obtained from Vietnam is that as the market economy evolves the role of direct or administrative control is reduced and the need for conventional monetary policy strategy increases. The experience of Vietnam, and even China, suggests that there is no special monetary policy strategy for socialist market economies; both have tended toward an international approach, albeit with more controls on the exchange rate and the financial system.

**Fig. 5.4** Vietnam: Interbank interest rate (overnight) and the operational target of monetary policy (base rate), 2008–2010. *Source: Le Dang (2011)*



## Financial Transformations

In the 1990s, the Cuban financial system was subject to intense transformation. A two-tiered financial system was created that replaced the previous scheme of a single bank that functions as a central bank and at the same time has commercial functions, as was typical in socialist countries. In 1997 the Central Bank of Cuba was created as an umbrella organization for banking supervision and the payment system; it was also responsible for monetary and exchange rate policy. To some degree, the banking system obtained independence from fiscal policy and in turn could be tempered to the new domestic and international stage after the demise of the socialist countries and Cuba’s partial opening to foreign investment, the tourist industry, remittances and some market spaces, among other changes from the reform of those years.

New commercial banks and nonbanking financial institutions were created, all state-owned but with a certain level of autonomy for client selection, risk management, and in general, with authority for credit decisions made within parameters defined by the Central Bank. Legally established foreign private financial institutions were allowed into the country, but only to open offices representing their main headquarters. Within a limited legal framework, some of them have been offering credit and financial services related to joint ventures and also to SOEs.

Currently, the Cuban financial system is integrated by eight state-owned commercial banks (SOCBs), a bank with joint state capital from Cuba and Venezuela (Banco Industrial de Venezuela-Cuba), nine non-bank state financial institutions, and 15 representatives of foreign financial institutions. The financial system achieved some progress in upgrading, computerization and the development of new services and tools to capture savings and credit allocation.

The Central Bank has been setting interest rates on sight deposits and fixed term deposits for state banks, while defining narrow ranges for interest rates on loans.

Implicit interest rates on other types of credit transactions, such as discounting bills of exchange and financial leasing, as well as loans from foreign institutions with domestic office representation or located abroad have been further freed from regulation. Some competition among financial institutions has appeared, but within a very limited framework. The interbank market, one of the first issues addressed by the Guidelines, never achieved its potential, except for sparse interbank lending operations and deposits between financial institutions.

In this context of the direct control of interest rates, low competition, and lack of an interbank market, monetary policy transmission mechanisms through the banking system have not been practicable (Vidal 2012b). Decree Laws No. 172 and 173 of 1997, which established the legal framework for the functioning of the Central Bank and the rest of the financial system, and which remain valid, left the door open to the use of the reserve requirements and the discount rate as instruments of monetary policy. In practice, however, they have never been used for such purposes.

On the other hand, the possibility of using open market operations has not been available because of the absence of a primary and secondary market for government debt. Nor are there any Central Bank bonds or other financial instruments that would serve to collateralize operations of expansion or contraction of the monetary base through the discount window. The absence of low-risk financial instruments, in turn, has restrained the development of an interbank market.

To address this, a first proposal of the Guidelines is:

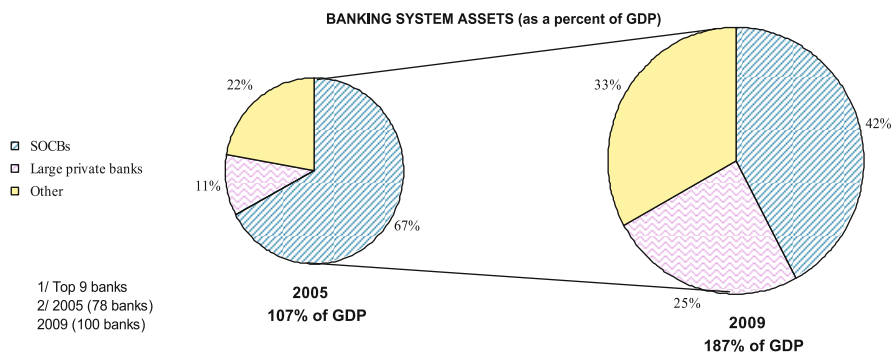
To develop an efficient interbank market that facilitates, among other things, structuring a more rational and meaningful interest rate system, and that promotes the use of monetary policy instruments.

A second transformation in the financial markets, as proposed in the Guidelines, is in the opening of credit to individual citizens. Financial institutions have developed their credit work primarily in the business sector, and only in a very controlled way in the household sector. Loans to individuals have been associated, at most, with specific purposes within national programs regulated by the state. For example, sales of houses controlled by the state to individuals or the most recent replacement of more efficient appliances in a national program known as the Energy Revolution. These credits were never given directly in cash to a natural person; the funds were sent directly to the seller, in this case to a state enterprise, to limit use of the funds to the intended purpose.

In 1998 the Central Bank of Cuba issued Resolution No. 97, which permitted citizens to borrow cash loans directly from banks for their own purposes. This was implemented for some years, but later canceled.

The third and last point is that the financial transformation that appears in the Guidelines is intended to prepare the banking credit and services for non-state forms of production. The text quotation is as follows:

To provide the necessary banking services, including lending, to the non-state economic sector to contribute to its proper functioning.



**Fig. 5.5** Vietnam: Banking system ownership, 2005 and 2009. *Source:* Le Dang (2011)

These are among reforms in the financial system that are planned for implementation during the 2011–2015 period. As stated, the document is declarative, allowing us to see only some general goals. Nevertheless, there are some notable absences in the text suggesting the limits of this financial reform. The first impression is that, from a monetary and financial viewpoint, current economic reform seems much less comprehensive and intense than that carried out in Vietnam.

For comparison, some of the most important financial changes that occurred during the Vietnamese reform process are summarized below:

1. Since the 1990s, a two-tiered financial system has been established.
2. During the 1990s, new banks were created and the types of financial institutions diversified. Modernization and computerization of the banking process was initiated.
3. Entry of foreign banks and diversification of ownership of commercial banks led by the process of selling shares gradually occurred (equitization).
4. In 1993, Vietnam joined the IMF, the World Bank and the Asian Development Bank.
5. In 1995, Vietnam began to liberalize interest rates (completed in 2002).
6. In 1995, government bonds were issued and the development of auctions was begun.
7. In 2000, open market operations to control the monetary base and the interbank interest rate were used for the first time.
8. The reform continues. A new law for the State Bank of Vietnam has been passed.

The Vietnamese banking system is currently formed by four major SOCBs, 37 joint-stock banks, 37 foreign bank branches, six joint venture banks and two development banks. SOCBs hold 42 % of the banking sector assets, but with a downward trend. For instance, in 2005, SOCBs held 67 % of overall assets and in 2009 this was reduced to 42 % (see Fig. 5.5). At present, foreign banks control 12 % of the credit market. In spite of the significant transformation and development, some weaknesses persist in the Vietnamese banking system. There is a high level of

non-performing loans, a credit system biased toward SOEs, and fragilities in the banking supervision and informal finances, especially in rural areas (Dollar 2002; Leung 2009).<sup>13</sup>

Cuban financial reforms during the 1990s reached point two of the Vietnamese path outlined above, and then stopped. The visible contents of the current reform do not suggest that it is intended to continue to any of the other points. Disregarding some of these points, however, could make it more difficult to achieve the goals proposed by the Guidelines.

For instance, the development of an interbank market requires liquidity and low-risk financial instruments for the collateralization of overnight and short-term loans. The issuance of government bonds would help in this regard, and would also include a future for open market operations and the increase of the use of monetary policy instruments. It will also be necessary to promote the fledgling competition that emerged in the 1990s, as well as greater flexibility in interest rates.

The development of an interbank market would be more expeditious if the creation of joint venture banks with foreign capital is promoted. Right now, the Cuban banking system is going through a liquidity crisis. Foreign banks could aid the entry of capital and financial technology to support the interbank market and, particularly, the other two aspects the Guidelines refer to: credit to the non-state sector and personal loans.

Many foreign banks would not dare to enter the Cuban market because of restrictions imposed by the US embargo, but where there is a possibility, Cuba should evaluate it pragmatically. Some mixed-ownership banks with state and foreign capital may grow out of the currently existing offices representing foreign institutions. This will also help to outmaneuver the US financial embargo.

## Conclusion

Early indications are that Cuban monetary and exchange rate reform will focus on the unification of currencies, the development of an interbank market, the opening of personal credit and loans for the non-state sector, and the improvement of the strategy for monetary policy management through greater coordination and the establishment of rules. Taking into account the Vietnamese reform, and the changes that seem necessary to achieve the goals articulated in the Guidelines, a series of gaps in monetary and exchange rate reform can be identified, such as the issuance of government bonds, the entrance of foreign banks, greater competition and more flexibility in interest rates, as well as issues related to the transparency of monetary

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<sup>13</sup>Dollar (2002) stated that: “Vietnam made an initial set of reforms in the financial sector, but the banking sector is still dominated by a few, poorly managed state banks. Much of the outstanding credit of these institutions is to state-owned enterprises. Some of the SOEs, especially those working with foreign partners, are doing well, but many are in financial difficulty. Hence, the financial sector is saddled with a large degree of non-performing loans. This results in high spreads and poor ability to channel funds to the most productive investments... it also represents a contingent liability that weakens the government’s fiscal position.”

policy. It seems that there is no special monetary and exchange rate policy for socialist market economies. Therefore, the sooner the Cuban Central Bank starts developing the conditions for conventional monetary and exchange rate strategy the better.

Devaluation of the exchange rate for SOEs, joint venture companies and government institutions is unavoidable. It should be done more gradually than in Vietnam, because the high share of medium and large SOEs in the Cuban economy makes it less prepared to respond to exchange rate incentives. Devaluation of exchange rates, fiscal restraints, labor adjustment and liberalization are pieces that could fit together if a suitable balance and proper time orchestration is achieved; otherwise, high inflation will rebound in the Cuban economy. Liberalization should not only focus on agriculture and microenterprise, it should also be extended to a non-state sector of a larger scale as well as FDI in order to boost productivity and take advantage of the high level of social development, especially education.

Monetary and exchange rate reform combined with a more comprehensive liberalization process will facilitate the discovery of new engines for export and economic growth and overcome the domestic financial crisis. The changes should not occur all at once, which would overlook the particular initial conditions of the country and, as a consequence, fracture macroeconomic and institutional stability. As can be seen from Vietnam, even with a “big bang” approach applied in some periods, the reform took several years to complete significant transformations of the economic system. Yet Cuba should try everything possible to speed up its process to recover lost time.

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# Chapter 6

## Food Production and Import Substitution in the Cuban Reform Process

Anicia García Álvarez and Armando Nova González

### Introduction

Since General Raúl Castro became president of Cuba, he has frequently expressed deep concern about issues related to the country's agricultural sector, as might be expected. The agricultural sector is critical to economic development; it increases the food supply for domestic consumption, frees up the workforce to be employed in secondary and tertiary sectors, expands the market for products from industry and services, and increases the availability of domestic savings to finance investment and acquire foreign exchange.

Unfortunately, the Cuban agricultural sector performs some of these functions poorly. It can only fulfill its role if the productivity of the sector itself is improving, which would free up resources for other activities at the same time the primary functions of feeding the population and obtaining hard currency are addressed. However, the productivity gap between the Cuban agricultural sector and the rest of the country's economic activities is big enough to conclude that this industry, far from contributing to the economic development of Cuba, has become one of its primary obstacles.

Economic history has demonstrated that devaluing the agricultural sector or extracting excessive resources from it to support other ventures when the sector itself is not experiencing significant growth is usually not an inconsequential decision. This is what has happened in the Cuban case: currently the agricultural sector barely reaches 60 % of 1989 production potential. It suffers from a significant loss of investment, and even though it no longer has the distinct export bias it had during a significant part of our history, it has not been able to substantially increase its contribution to food available for domestic consumption.

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This chapter is based on several previous studies on food import substitution in Cuba. Its objectives are to analyze the Cuban agricultural sector's performance with respect to supplying food, the consequences of failures to do so, and what opportunities exist to improve the sector's contribution to major foodstuffs, as well as make economic policy recommendations to help mitigate the prevailing situation.

As background, we begin with an overview of the evolution of agricultural land distribution in Cuba to provide a sense of the relevant actors in current Cuban agricultural production as well as the impact of contemplated changes for agricultural policy. In addition, we analyze the recent performance of food production to illustrate the urgency of agricultural transformation in Cuba.

## Methods Used

The following methods have been used: literature review; specific documentation of the Cuban case; comparison between estimated production costs for some goods in Cuba and the price of competitive imports; and analysis of the Guidelines of the Economic and Social Policy of the Party and the Revolution, specifically those setting a benchmark for the future transformation of Cuban agriculture and its economic environment.

Mathematical modeling methods and other statistical tools have also been applied to explore the determinants of the demand for imports of these food products in the country. Time series have been composed from information provided by the National Statistics Office (*Oficina Nacional de Estadísticas*—ONE) and information from its periodicals.

## History of Ownership Structure in Cuban Agriculture and Recent Changes

Historically, the Cuban economic model has had various forms of land use and ownership. Smallholders and medium-sized farms characterized land distribution for the first 400 years of Cuba's colonial and post-colonial history. This structure did not change until the late nineteenth and early twentieth centuries. In the 1902–1959 period, US capital inflow led to the emergence of large estates, which aggravated inequalities, removed agricultural producers from the land and developed an agricultural model based on monoculture and a single export item. As a result, the Cuban economy became increasingly dependent on food imports, which in turn led to food vulnerability. The agrarian issue is crucial for the proper performance of the Cuban economy and society.

The implementation of the first and second Agrarian Reform Acts, which benefited landless agricultural workers, also led to the emergence of the state sector in

**Table 6.1** Land leases through December 2012

	Quantity (unit)	Area (1,000 ha)
Natural persons	172,000	1,369,000
Legal entities	2,554	153,920
Total	174,554	1,522,920

*Source:* Nova A. Cuban Agriculture and Political, Economic and Social Guidelines (2012)

agriculture. After 1959, land was divided into large estates, leading to the creation of large, over-sized enterprises, which remained in place until 1993. In practice, these decisions resulted in a decrease in the number of farmers; in 1990 they occupied 18 % of agricultural land. While in 1958, 56 % of the Cuban population was rural, in 1999 this figure dropped to less than 25 %.

The predominant form of ownership in the Cuban agricultural sector in the 1959–1990 period was the over-sized state agricultural enterprise (state-owned entities), and to a lesser extent, cooperative schemes, such as Cooperatives for Agricultural Production (*Cooperativas de Producción Agropecuaria*—CPA) and Cooperatives for Credit and Services (*Cooperativas de Créditos y Servicios*—CCS).

During the economic crisis in the 1990s, production relations were significantly transformed by the establishment of Basic Units of Cooperative Production (*Unidades Básicas de Producción Cooperativa*—UBPC), which were created alongside CPAs and CCSs. This development reflects the fact that cooperativism became the fundamental basis of the Cuban agricultural model during the 1993–2008 period.

However, since they were established in 1993, UBPCs (currently the most common cooperative form) have operated under certain restrictions that limit their performance and potential. These limitations have contributed to the UBPCs being identified as state enterprise-like entities.

The agricultural sector is composed of five types of productive entities: UBPCs, CPAs, CCSs, private farmers, and farmers working the land under leasing agreements. These modalities have corresponding forms of land ownership and use.

Notably, CCSs and private farmers have shown the greatest efficiency; currently, these two modalities produce 57 % of total domestic food production with only 24.4 % of the arable land. They only comprise 3.7 % and 1.7 %, respectively, of the land reported as idle. Additionally, they produce 56 % of the total milk production (the state produces 15 %), have more than 55 % of the dairy cows and over 50 % of all cattle, and own 59 % of pigs.

Recently, leasing of idle land through Legal Decrees 259, 282, and 300, has radically changed the panorama of land distribution among agricultural workers in Cuba. Table 6.1 summarizes the amount of land distributed and recipients through the end of 2012.

Leasing idle land is leading to a new agricultural model that consolidates the predominance of non-state producers, especially CCSs and private farmers, which account for between 18.5 and 51.0 % of land tenure (see Table 6.2). Since the data show these are usually the best producers, if the above measures are implemented in a systematic way, we could expect increasing production and efficiency levels.

**Table 6.2** Forms of land tenure in Cuba (%)

Agricultural area	Total	State	Non-state	UBPCs	CPAs	CCSs and private farmers <sup>a</sup>
2007	100	35.8	64.2	36.9	8.8	18.5
2011–2012	100	17.0	83.0	23.0	9.0	51.0

*Source:* Prepared by the author based on the National Statistics Office (ONE) (2009, 2010) and estimates<sup>a</sup> based on the Land Department report, Ministry of Agriculture

**Table 6.3** Non-state agricultural entities in Cuba: UBPC, CPA, CCS and small producers, December 2012

Entities	Number of cooperatives	Agricultural area (1,000 ha)	Members	Productive scale (ha)	Individuals per ha
UBPC	1,983	1,853.4	160,000	934.6	0.09
CPA	995	590	53,961	592.9	0.09
CCS	2,518	1,242.0	352,565	493.2	0.28
Individual farmers		390	50,000	7.8	0.13
New leaseholders (decrees 259, 282 and 300)		1,369.0	172,000	7.9	0.13

*Source:* Nova A. Cuban Agriculture and Political, Economic and Social Guidelines (2012)

The emerging model indicates that the predominant form of land tenure will be non-state, especially the CCS and the new beneficiaries of land leases to individual producers. Finally, Table 6.3 contains more details on the four types of non-state entities in the Cuban agricultural sector. The ratio of available workers to agricultural area is more favorable for CCSs and individual producers, which suggests better utilization of human resources by those entities.

The aforementioned measures favor small and medium-sized enterprises, both in land use and ownership. This doesn't mean a total return to the late nineteenth century pattern,<sup>1</sup> but the new modality is rooted in the forms predominant at that time. The emerging land tenure system is strengthened by collective forms of production and producers' knowledge transferred across generations, and enriched by scientific and technical development. This transformation of land tenure is illustrative of the direction of Cuba's agriculture sector.

## Agricultural Production, 2009–2012

Four years after the first measures were introduced to transform the Cuban agricultural sector, the results have not been as expected: between 2009 and 2012 agricultural production has declined, or in the best cases, has remained flat or experienced few and insufficient increases.

<sup>1</sup> Cuban land records from 1899 indicate a preponderance of small and medium farms in relation to larger farms.

In 2009 agricultural and livestock production taken together finished the year at a stable 100.5 % of 2008 levels. However, food crop production grew by 5.65 %, while livestock production decreased by 4.6 %.

In 2010 the agricultural sector declined by 2.8 %. Crop and livestock production fell in 12 fundamental areas, such as: rice, pork, eggs, vegetables, beans, tubers (potatoes), citrus fruits, poultry and others.

In 2011 agricultural production grew by 8.7 % (crops 11.5 % and livestock 6.0 %), according to ONE.

The volume index for agricultural production in 2012 shows a decrease of 1.3 %. Crop production increased by 1.7 %, and livestock decreased by 4.3 %.

The sugar cane harvest in 2009–2010 also decreased, reaching extremely low levels, while the 2010–2011 harvest showed a slight recovery that continued into 2011–2012.

The complex domestic economic situation combined with the persistent global economic crisis, and especially, insufficient domestic food production—despite the sector's significant productive potential—compels urgency in adopting new measures to reactivate the utilization of this potential.

Due to a serious reduction in the supply of agricultural goods for sale during 2011, average prices for agricultural and meat products rose by 19.8 %. Crop prices increased by an average of 24.1 % and meat prices by 8.7 %. However, the data showing increased agricultural production reported by ONE for 2011 are inconsistent with this decrease in the food supply and consequent price rise.

Thus, the 2009–2012 period experienced diverse outcomes in the agricultural sector (stagnation, insufficient growth, downturn), which reflect an unstable trend that is tending toward decline. Shortfalls in domestic food production have continued, leading to significant outlays of foreign reserves for food imports. It is evident that productive forces in the agricultural sector are still curtailed, necessitating the elimination of obstacles that continue to restrain their development. These issues suggest the necessity of continuing the transformation of production relations as quickly as possible in this sector, since it is so strategic for the Cuban economy.

## **Production and Import Substitution of Foodstuffs, Principal Findings**

The agricultural sector's role in increasing the food supply is our first concern. In the early 1990s, Cuba faced a major food shortage after losing its business linkages with the former USSR, which had provided large amounts of food for consumption, as well as equipment and inputs for domestic agricultural production. Cuban agriculture had become too dependent on these imports and was not prepared to deal with such a large external shock. During the period after 1989, the food supply decreased to the point that it could not meet nutritional requirements, which caused health problems such as the neuropathy epidemic and an increase in underweight births.

Beginning in 1994 this picture began to improve. The FAO-recommended levels for energy were exceeded by 2000, and for protein by 2003. However, this recovery was achieved largely from food imports (see Fig. 6.1<sup>2</sup>). This is not a new phenomenon: Cuba has traditionally been a food importing country as a result of its specialization in the sugar industry and other agricultural exports, which occupied a significant proportion of the nation's farmland. According to estimates made by the author, in 2007 the contribution of imports to the provision of energy was at a level similar to the 1950s, while imports' contribution to protein supply was greater than in the 1950s and also exceeded that of the 1980s.

Domestic food production began to grow after 1994, but some products still do not reach the levels achieved in 1989 (see Fig. 6.2). In the case of rice, which is the most important grain in the Cuban diet, production still has not risen above 1980s levels. Considerable setbacks have occurred in both meat and dairy cattle production. Similarly, poultry production remains depressed due to its low competitiveness, especially after food imports from the United States began in 2001.

Food products with better productive performance are those authorized to be sold in the agricultural market (including tubers, vegetables, beans, corn and fruits), as well as those that have been promoted by special programs. The latter include pork and egg production, which have benefited from special support since these activities can yield speedy productive results and the available technologies are managed efficiently.

In view of the current international context, Cuba's potential to sustain this level of food imports is not promising. Imports have already increased in the new century (see Fig. 6.3) as a result of increased quantities purchased as well as the rising trend in prices.<sup>3</sup>

Cuban food product imports (see Fig. 6.4) have included other grains<sup>4</sup> for livestock feed and foodstuffs for human consumption. Additionally, in the absence of domestic production, fat- and protein-enriched livestock feed has constituted a significant portion of imports.

Nevertheless, in recent years more than 50 % of food purchases abroad include a number of commodities that could be produced domestically, such as rice, dairy products, eggs, fish and meat and their by-products, and even coffee. Indeed, domestic production capacity for these goods is limited by lack of incentives, inputs and investment because there has not been sufficient allocation of the hard currency necessary for further expansion of production and producer stimulus. As a result, foreign exchange used to import these items ends up in the pockets of

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<sup>2</sup> All figures are found in the appendix.

<sup>3</sup> According to the Institute for Agriculture and Trade Policy (IATP) (2008), among the most important reasons for this trend are the following: market power concentrated in a group of transnationals, which can fix prices by controlling supply; significant rise in the price of oil, which is key to industrial agriculture; continually expanding proportion of grain production (both cereals and oil seeds) dedicated to biofuels; financial speculation in commodity markets; and climate change, which generates extreme climate patterns that seriously damage food production.

<sup>4</sup> All grains, except rice.

international food brokers, rather than benefiting Cuban farmers and entrepreneurs in the agricultural business.

Until the Cuban agricultural sector fully recovers, the country will have to spend part of its foreign exchange earnings purchasing food, since it is a basic consumption need that cannot be postponed. As a consequence, there will be less foreign currency available for investing in new activities.

According to by OECD-FAO<sup>5</sup> (2008) projections, prices for principal foodstuffs will be above 2005 levels as far out as 2017. Despite the deflation that took place after the 2008 boom in commodity prices, they have subsequently risen again (see Fig. 6.5) and are not expected to return to pre-crisis levels.

Thus, substitution of food imports in Cuba is a matter of great importance. We have been addressing this issue for more than a decade (see García et al. 1996, 1997, 1998, 2010, García 2006, 2009). In particular, we have systematically studied the cases of rice, legumes (beans, peas and other grains), and dairy products, as well as the potential for vegetable fats. In the case of these foods, imports have grown not only in terms of value (see Fig. 6.8), but have also tended to increase in quantities.

However, after 2007, milk imports stabilized and there has even been a decline in rice imports; the same has been true for beans after 2008. These conditions reflect the effects of tougher restrictions on the availability of foreign exchange as a result of the impact of the global crisis on the Cuban economy. To adjust to the shock, many steps have been taken, including reduced consumer food subsidies. The effects of some measures taken to revive the Cuban agricultural sector have also become evident, such as increased rates for State purchases of agricultural products and the leasing of idle land.

After the 1989–1993 shock, and especially after 1994, modest improvements had been made in domestic capacity to produce foods for consumption; these improvements were lost after 2000. Fortunately, domestic production of these foods performed better from 2006 on, and the country is better off in this regard (see Fig. 6.6).

García (2009) showed that estimated costs for domestic milk and rice production exceeded the prices of imported sources, controlling for exchange rate value (see Fig. 6.7b). This is a consequence of low yields per dairy cow and rice harvesting unit.

But if we limit the comparison to the foreign exchange content of national costs, domestic production is more affordable (see Fig. 6.8b). In the case of milk and beans, foreign exchange content is lower than the import price. In the case of rice, foreign exchange content below import cost is potentially attainable through improved yields, even with the overvalued official exchange rate.

Cost and price comparisons for 1997 and 2007 (see Figs. 6.7 and 6.8) indicate that the current situation is significantly better for import substitution:

- The agricultural price policy has ultimately bridged the gap between prices paid by the State-owned company that buys domestically produced agricultural

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<sup>5</sup> Acronyms in English for the Organization for Economic Cooperation and Development (OECD) and the Food and Agricultural Organization (FAO).



products and prices at the agricultural markets (or informal markets, as in the case of milk), making sales to the State more profitable, which are directly connected to import substitution.

- Thus, the official prices paid by the State-owned company are already covering production cost estimates for the cases studied, so that producers can obtain a favorable price selling in bulk to the State. The widening of this margin is a result both of increased official prices and the decrease in costs.
- The gap between estimated production costs and import prices also shrank due to movements in both directions: of prices upwards and costs downwards.

In order to test whether food imports to Cuba respond according to conventional economic theory—namely, they respond negatively to competitive domestic supply and world market price, and positively to the country's income—demand functions were estimated using data from the 1980–2006 period for dairy products, beans and rice, and from the 1980–2008 period for fats (see tables in Appendix). The results for the long term indicate that for import demand:

- Powdered milk is unaffected by changes in import prices or the country's income, and reacts only slightly (in inelastic fashion) to adjustments in the domestic supply of milk.
- Beans also are not sensitive to changes in import prices and income. However, elasticity with respect to domestic production is positive, contrary to what is expected. This may reflect the fact that much of the bean production is traded outside distribution mechanisms under State control,<sup>6</sup> so that even with increasing domestic production, imports did not react to this favorable development.
- In the case of rice, long-term elasticity for external prices is greater than one, indicating that rice imports react to price changes at a greater than proportional rate. Elasticity corresponding to domestic production is below one, indicating that the reaction to the amount of import demand is inelastic. The income elasticity of the country has an appropriate sign, but it is not significant.
- In the case of aggregate fat imports, the Gross Domestic Product (GDP) variable has the expected effect and prices have a significant impact. However, the sign for domestic production, which shows a positive correlation, contradicts economic theory. This indicates that a substitution effect does not occur between domestic and imported sources; rather, they are complementary, since the country has a deficit of fats, which leads to significant import dependency to meet this need.

These correlations indicate the need to implement economic policies that support the appropriate performance of agricultural producers under existing conditions in the foreign and domestic markets, and in particular, to increase the elasticity of imports relative to domestic production.<sup>7</sup>

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<sup>6</sup>See García (2006).

<sup>7</sup>In absolute terms.

We cannot lose sight of the fact that the agricultural sector's performance is affected by both general and specific economic policies. General policies are those that determine the economic environment in which agriculture operates, while specific policies comprise specific instruments that are applied to influence activities carried out within the sector. Among the most important components of economic policies are the following: macroeconomic (fiscal, monetary and exchange rate), trade, price or revenue, research and technology transfer, industrial<sup>8</sup> policies and property rights.

An assessment of Cuba's economic policies indicates that the policy environment does not favor import substitution generally, not just food imports. For example, from a fiscal point of view the agricultural sector receives a significant amount of resources. However, much of this support comprises assistance to producers who struggle to achieve profitability because of specific agricultural pricing policy and distortions caused by an overvalued exchange rate. Moreover, this exchange rate does not help promote exports, much less import substitution.

The current monetary arrangement does not favor production for the domestic market either, since producers earn domestic currency, while their main inputs have to be purchased in foreign currency.

Official prices paid by the State have trended upward, providing further incentive to producers. This is associated with a degree of hard currency purchasing power for inputs that is directly proportional to official sales. Nonetheless, domestic price increases are not in line with the rise of global prices, and foreign exchange allocated to support production is still insufficient to achieve complementarity with available labor and land resources.

Another food-related problem in Cuba is linked to distribution and high food prices in the markets, where additional products have to be bought to complete the basic food basket obtained through rationing and other subsidized distribution sources (see Fig. 6.9). Food distribution through ration cards is not enough to meet nutritional requirements. There are other subsidized distribution channels, such as social consumption, public consumption and consumption of self-produced food,<sup>9</sup> but they are not available to everyone.

Thus, the level of benefits families receive from such channels determines the extent to which they will have to shop in markets, which has a major impact on the level and composition of their food expenditures. To illustrate this, we estimated per capita food expenditures based on food distribution in 2006 measured by the National Office of Statistics (2006b) according to source (or distribution channel),

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<sup>8</sup>This includes the most general meaning of the term *industry* as any economic activity, including of course the agricultural industry.

<sup>9</sup>Social consumption includes food consumption in public institutions such as schools, hospitals, homes for the elderly, and other related institutions. Public consumption includes food sales through the gastronomy network, as well as related sales made to the population as a secondary activity outside this network, and sales in workers' cafeterias and snack bars. Consumption of self-produced food refers to production for consumption by the production enterprises themselves, for their workers and members, in the case of companies and cooperatives rendering that service, and production for family consumption in the case of the private sector.

and whether or not it was subsidized (see Fig. 6.10). The amount spent on food in the markets was based on prevailing prices for that year.

Access to a subsidized food source in addition to the ration allotment determines the level of expenditures on food. For urban families, who usually have no access to self-produced food, we only considered social consumption and public consumption benefits; their subsidized supply accounts for 16–47 % of their total food consumption, and market purchases, between 84 and 53 %.

Subsidized food prices (rationed food supply, social consumption, public consumption) or at prices equal to cost (self-produced), contrast sharply with market prices (agricultural market, sales in hard currency and the informal market).

Estimates of food expenditure by the Cuban urban population total 62–75 % of all consumption expenditures (see García and Anaya 2006). Ferriol et al. (2004) reported that food expenditures of the population in Havana in 2001 amounted to 66.3 % of total expenditures. Such a high amount of income spent on food is a distinctive feature of economies with low levels of development and represents a very stressful situation for Cuban families.

Persistently high prices in the nonsubsidized sector are closely related to the imperfect nature of those markets. For example, in the agricultural market there are still limitations that restrain competition and its potential efficiency. These include: minimal supply in these markets,<sup>10</sup> given the rules of access required for vendors, lack of markets for inputs to expand production, which is also due to undercapitalization of the sector; tacit collusion among the market's agents because of access rules and the lack of transportation services for these goods.

After the completion of these studies, the Guidelines of the Economic and Social Policy of the Party and the Revolution<sup>11</sup> were released. They set forth the principal actions for the transformation of the Cuban economy in the coming years, so it is essential to analyze them from the perspective of the subject we are considering.

## **Food Production and Import Substitution Under the Guidelines**

The Guidelines devote an entire chapter to the changes to be made in the Cuban agro-industrial sector. However, as discussed above, sector-specific policies are insufficient without attention to the broader economic policies that determine conditions for profit. The rules of the game under the economic system, addressed in the chapter on the economic management model, are equally important. Thus, we will analyze which provisions in both the general and specific fields will support the goal of increasing domestic production and import substitution of food products.

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<sup>10</sup>Physical sales at the agricultural market do not exceed 10 % of domestic production of most products in supply.

<sup>11</sup>Hereinafter referred to as “the Guidelines.”

The first Guideline for the management model emphasizes the central role of planning in the economic administration of the country, which “will consider the market, have an influence on it and consider its characteristics” (CPC 2011, G-01,<sup>12</sup> p. 10). This raises the issue of whether Cuba could have any non-marginal influence on the global food market, given its market size from both, demand and supply sides.<sup>13</sup> Could Cuba be in any position other than price-taker, at least for the primary foodstuffs included in its basket of imports, and therefore, should it focus on closely tracking the global market and adopting policies most likely to lead to food sovereignty? In other words, G-01 obviously refers to the country’s domestic market and we must emphasize that there is an external market that must be considered in our economic policy choices, for example, in pricing policy.

In G-09, reference is made to development of markets for the supply of inputs and equipment leasing, which must also provide services to the non-state sector of the economy. This approach is in line with our suggestion of a more decentralized agricultural management model, where producers (from any property regime) may establish the combination of productive factors that best suits their specific conditions. However, this is one of the measures that has not been implemented yet, which may delay the necessary revitalization of food production and its potential impact on import substitution.

Guidelines contained in the chapter on the management model, targeting both the private and cooperative sectors, call for greater efficiency throughout the system. This should have an impact on food import substitution by improving the competitiveness of domestic products.

In particular, G-29, which supports the creation of secondary cooperatives, opens a window of opportunity for the emergence of marketing cooperatives,<sup>14</sup> both for foodstuffs and agricultural inputs, based on the already existing cooperative organizations in the agricultural sector (CPA and UBPC and even CCS<sup>15</sup>). Marketing cooperatives could lead to a radical change in current food distribution channels, which are mainly concentrated in the state-owned enterprise for purchasing and distributing agricultural products. The state company faces a number of pressing problems, such as significant losses throughout the production chain, delayed payments to producers and excessively low prices. This situation works against increased food availability and import substitution of these products.

In the area of monetary policy, G-50 provides for the opening of credit lines based on import substitution support. The determination must favor the purpose of substituting food imports. However, this displaces the problem to the chances of

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<sup>12</sup> Hereinafter reference will be made to each guideline and its consecutive number with a capital letter “G” followed by a hyphen and the relevant number.

<sup>13</sup> Sugar cane is an exception in this context, even though its production has decreased dramatically during the last decade.

<sup>14</sup> In some Nordic countries, even where there are no cooperatives for agricultural production, marketing of food products and inputs is done through cooperatives (see García 2011).

<sup>15</sup> CPA (Cooperatives for Agricultural Production); UBPC (Basic Units for Cooperative Production); CCS (Credit and Service Cooperatives).

recovering the cost of the credits, in case other provisions covering the management model and policies for marketing and agricultural prices are not successful. In particular, G-53 specifies credits available to the non-state sector, which is important because agricultural production is concentrated in this sector.

In our view, the largest gap is in exchange rate policy. This is a decision that influences the levels of prices throughout the economy which, given the level of imports that supports food consumption, will have a considerable impact on the consumer price index. Nevertheless, in our opinion, setting a more objective exchange rate is essential to progress in the agricultural sector. Given its importance, it is worth exploring the possibility of setting a specific exchange rate to stimulate import substitution, until a decision is made that covers the whole economic system. A similar policy is already being applied to import substitution projects, at a rate of 10:1.

Regarding fiscal policy, there are three guidelines that directly support the production of agricultural goods (including food products) and import substitution: G-58, which provides for the creation of a differentiated tax system to stimulate the agricultural sector, G-61, which reaffirms financial incentives for key economic activities, such as import substitution, and G-62, which seeks to update the role of tariffs in the economic model, promoting special schemes and bonuses to support profitability of products that substitute imports. Importantly, these provisions require that the procedures for obtaining support are made viable. Experience with similar provisions aimed at stimulating growth of exports indicates the desirability of more transparent and expeditious rules.<sup>16</sup>

As for pricing policy, under G-67, a comprehensive review of prices to stimulate import substitution is projected. This is based on the assumption that prices will be controlled by an authority. We will return to this issue in the discussion of specific guidelines for the agribusiness sector.

G-72 on foreign policy supports the integration of all policies (commercial, tax, credit, tariff, labor and others) to achieve the expected results from foreign trade, particularly effective import substitution. This provision is intended to prevent possible inconsistencies between export promotion and import substitution policies. However, it leaves out the determinative policy for these foreign trade-related purposes: exchange rate policy. It is too important to be placed among the “other” policies and for only one guideline to be devoted to it in the entire document.

In the area of foreign trade, emphasis is placed on the desirability of “fostering an accelerated process of effective import substitution, with mechanisms that encourage and ensure maximum utilization of all capacities available in the country’s agriculture sector,” in G-87. Likewise, G-90 addresses the need to take the necessary steps to meet import demands of the non-state sector of the economy. The latter is particularly important to import substitution, since most farmers are non-state workers who will need to import some inputs for efficient production.

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<sup>16</sup> A study conducted by the National Institute of Economic Research (INIE, in its Spanish acronym) (see Mañalich and Quiñones 2003, p. 32–44) demonstrated how difficult it was for entrepreneurs to access the fiscal support that their export activities entitled them to.

G-106 on foreign investment envisions its use in funding import substitution projects. Using foreign investment in this way is complicated, given potential challenges to recovering capital when targeting import substitution. However, it is very positive that this possibility was included.

The Guidelines also leave some space in G-129 to address policy priorities in science, technology and innovation, including import substitution. G-136 specifically addresses agro-industrial activity in a more comprehensive fashion from the standpoint of the productive value chain.

The social policy establishes the principles of subsidizing those in need rather than products, and the elimination of food rationing, in guidelines 173 and 174, respectively. Both objectives are closely related to the promotion of food production and import substitution. They establish market-based food production and compensate people with insufficient income to meet their food needs. These provisions constitute a shift away from the dominant paradigm of paying low prices to agricultural producers in order to maintain an adequate level of public access to food, toward market-based prices paid to producers and direct support to those people who cannot pay for food under these conditions.

Greater stimulus to producers through higher prices resulting from these decisions can become a driving force for higher production (for import substitutes as well). To this end, it is important to emphasize that the structure for food markets that is finally settled upon is critical. Currently, we are faced with a complicated design that is moving away from the purpose of encouraging increased production due to the imperfections of existing commercial spaces.

Specific guidelines contained in the chapter on “agro-industrial policy” relating to production and substitution of food imports include the following:

- G-177, which states the need to ensure that this sector is no longer a net food importer. Macroeconomic policies that are internally consistent will be vital to encourage import substitution.
- G-178, which calls for the adoption of a new model for Cuban agriculture, more in keeping with the prevalence of non-state modalities and the necessary decentralization and autonomy of producers.
- Guidelines 181 and 183, which refer to the problematic issue of agricultural marketing. G-181 calls for a better match between demand and supply of agricultural products. State purchases are expected to concentrate only on certain items, with the remainder operating in the market. At the same time, G-183 refers to the transformation of the distribution system, allowing for a straightforward link between producers and consumers.

This implies the need for properly designed food markets so that consumers as well as producers can benefit. Currently, sellers have significant pricing power, to the detriment of consumer welfare. Thus, the resistance of most of the population to the expected elimination of the rationing scheme is understandable, since being subject to the mercy of the market in its current form leaves consumers completely unprotected.

Therefore, restrictions on product competition should be eliminated, producers should be encouraged to create organizations to compete on their own, concentrations of middlemen should be eliminated, and greater competition leading to price equilibrium should be facilitated. We already mentioned the possibility of creating secondary cooperatives to address food marketing.

- G-182 addresses the important issue of the supplies and equipment market. Our economy has suffered from excessive centralization; in a centralized system it is very difficult to get efficient results in a sector such as agriculture, which is highly dependent on soil conditions, climate and other locally determined resources. This guideline is fully consistent with the need to promote greater responsibility for, interest in and commitment to results among all producers, as well as to achieve the proper complementarity among production factors wherever agricultural activities take place. These input markets could also be organized through secondary cooperatives.
- Guidelines 184 and 185 were specifically aimed at replacing food imports. G-184 covers substitution of foodstuffs that might be competitively produced domestically. As previously mentioned, nearly half of our food imports fall into that category. G-185 refers to the need for a systemic approach or the organization of productive linkages in these cases. The lack of comprehensiveness in past approaches caused losses that must be avoided.
- G-187 provides for continued reduction of unproductive land. Thus, the expansion of the agricultural frontier is extensively promoted. In fact, it is not clear that this can be a short-term goal, given the current restrictions on imports of inputs and machinery. Start-up production on idle land entails a significant effort to clear woody plants like *marabou*, which is difficult to achieve without the support of chemical inputs and mechanization.

However, G-187 also includes plans for diversification, rotation and intercropping of several species, reflecting more intensive land use in order to increase production, and applying existing resources in each territory. This goal had already been achieved on some Cuban farms during the difficult 1990s, and should be extended to those producers who have not yet introduced such practices. Nevertheless, this will only become more than a slogan when the agricultural management model is changed once and for all.

- G-188 is focused on seed production, which is essential to increase yields. Cuba depends on imported seeds for vegetables and potatoes, for example. In order to increase agricultural output beyond current levels, it is essential to guarantee an increase in seed production and ensure conditions for seed preservation to maintain quality and get good yields on commercial farms.

Many countries do not obtain high yields through chemical inputs; rather, they develop high-yielding species and varieties tailored to local conditions. Cuba has strong enough research capacity in the agricultural sector to achieve significant developments in this area, thus avoiding excessive external dependence on an issue as important as the provision of seeds.

- G-190 affirms the State's regulatory role in setting prices for import substitutes to improve incentives for producers while taking into account international

prices. This provision complements G-1, which did not take the external market into consideration. The specific pricing policy for this sector should ensure an appropriate response from producers referred to in the previous section: increasing supply while setting higher domestic prices, and that domestic prices reflect international conditions, so as to ensure an import substitution effect.

This issue of pricing is of utmost importance. Prices are the fundamental signal to producers in a market economy. They are the compass that guides producers in the allocation of resources to those areas that will ensure the best return.

However, producers prefer high prices, while consumers prefer low prices, or at least prices that accord with their level of income, especially for basic necessities, which is the subject of this chapter. So we are faced with a dilemma<sup>17</sup> that developed countries resolve through subsidies, both for producers facing extreme conditions<sup>18</sup> so they can maintain operations in the interest of food security, and for low-income households, which have difficulty accessing expensive markets.

This is a situation that we want to avoid, and perhaps can. The current structure of the food market poses precisely this dilemma. We reiterate that we must persist in finding a solution that allows for a better balance of interests between farmers, consumers and government.

- G-193 addresses the necessity for special programs to achieve substitution of imported grains such as rice, beans, corn, soybeans and others. Grains have historically accounted for about 50 % of Cuban food imports.

In sum, the Guidelines address virtually all the challenges facing food production and the need for import substitution. However, in addition to the declarations themselves, it is important to adopt appropriate sequencing in their implementation.

Currently, the tendency is to implement those measures that are most easily introduced, which does not always coincide with the most desirable policy. For example, self-employment has expanded as bloated State payrolls are deflated, which has led to the proliferation of small businesses conducting food retail sales. In the absence of wholesale markets where these new agents can secure their supplies, they have to compete with the rest of the population in the existing food retail markets. Given that food production has not yet reached required levels, the consequences of such measures are obvious: shortage in some market supplies and rising food prices. It is crucial to avoid such situations because this type of inadequate implementation can lead to the rejection of measures that are absolutely necessary.

## Conclusions

The economic crisis faced by Cuba in the 1990s had a significant impact on its agricultural sector. As a result, the contribution of domestic production to the nation's food supply continued to fall until 1994. Subsequently, some progress was made that needs to be stabilized and sustained.

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<sup>17</sup>Bu and Fernández (2011) refer to this trade-off as “the price dilemma.”

<sup>18</sup>These include difficult weather conditions or land with low productivity that leads to low yields.



Consistent use of available technologies is required to achieve productivity results that can compete with imports. Moreover, producers must have access to a combination of inputs tailored to their specific circumstances, even if hard currency expenditures are necessary. In any case, current expenditure of foreign exchange does not provide any return, since it is allocated to purchase consumer goods, and therefore fails to contribute to economic growth.

Domestic milk producers have been granted the right to buy supplies in hard currency in exchange for provisioning the State-owned food distribution system with import substitutes. This is an important measure that should be extended to all food-stuffs. Resources purchased in hard currency are crucial to complement factors of production available domestically (basically land and labor) and bring them up to full capacity. Likewise, a network of agricultural input suppliers should be created that should perform demand studies to determine producers' needs. This network can be organized by producers themselves through secondary cooperatives.

For many years import substitution has been an economic priority for the country, but in order to make this a reality, specific measures must be implemented to promote increasingly efficient performance in the agriculture sector. By creating an environment that favors producer initiatives to obtain competitive results, producers can become confident of economic success through providing food vital to domestic consumption.

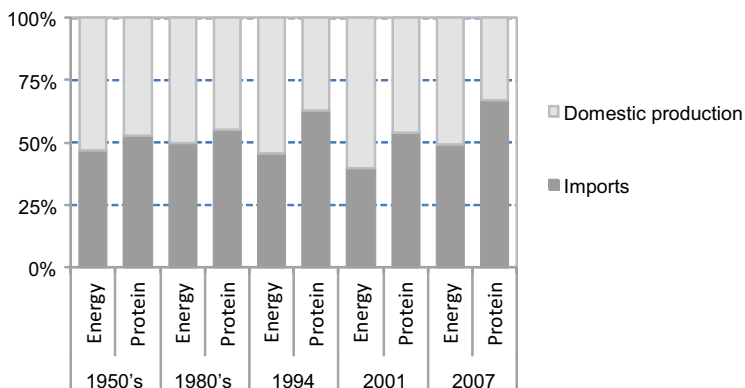
Moreover, contradictions between other macro-economic policies and efforts to substitute imports must be avoided. The principal problems arise from policies on agricultural pricing and exchange rates. Measures must be designed to achieve the appropriate balance of incentives for producers and importers so that import reduction is a function of rising international prices and increased domestic production.

The Cuban food market is characterized by high segmentation. This has consequences for household access, since a significant portion of income is allocated to food needs. A more homogeneous structure in this market could provide greater incentive to producers (who would receive higher prices), which would relieve the State of paying large subsidies to producers, shifting support instead to families in the lowest income bracket to ensure their access to food.

The Guidelines take into account almost all the recommendations arising from the current situation for agricultural production and food imports. However, decisions about exchange rate policy have yet to be made; these decisions will impact the profitability of domestic industry and its ability to compete with imported goods, and therefore, are of paramount importance to food import substitution. Additionally, food market restructuring to boost production incentives is still pending. How centralized distribution channels for basic items will coexist with food markets is an important issue in this regard. And finally, implementing the Guidelines in the appropriate sequence must receive careful consideration.

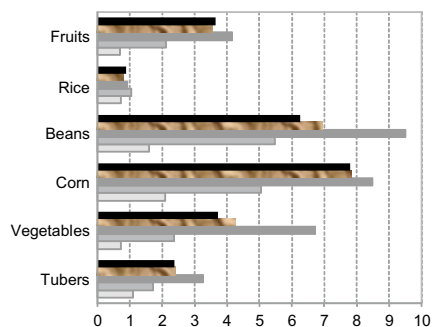
Despite the complexity of the problem, the possibility exists to reverse the trend in Cuban food production and curb imports. The current global food crisis environment must be definitively addressed as a window of opportunity for increased Cuban agricultural production that can substitute imports.

## Appendix

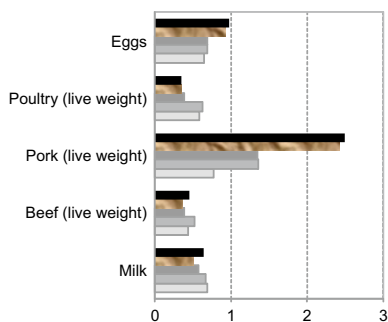


**Fig. 6.1** Share of imports in Cuban Food Supply, kilocalories and proteins. *Source:* Prepared by the author based on Marcos 1987, and National Statistics Office (ONE) (2005, 2006b, 2007, 2009)

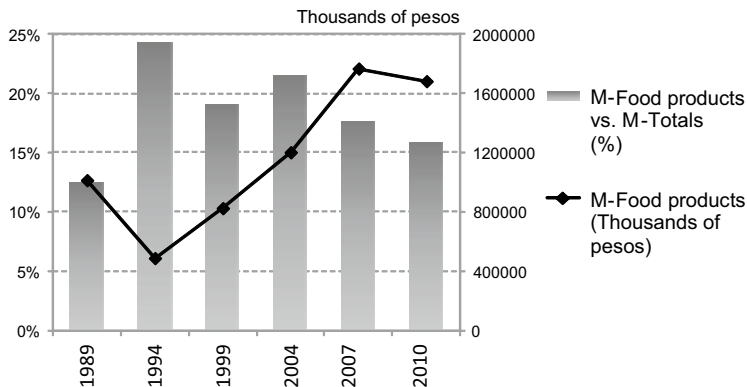
### Agricultural Products



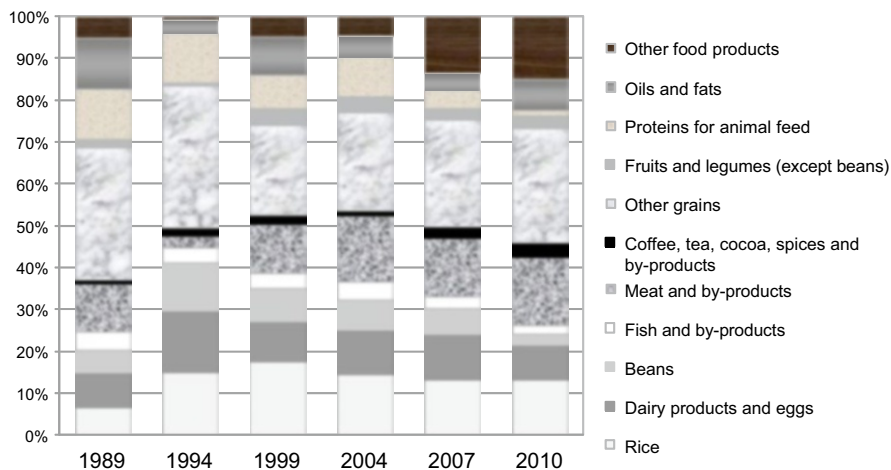
### Livestock Products



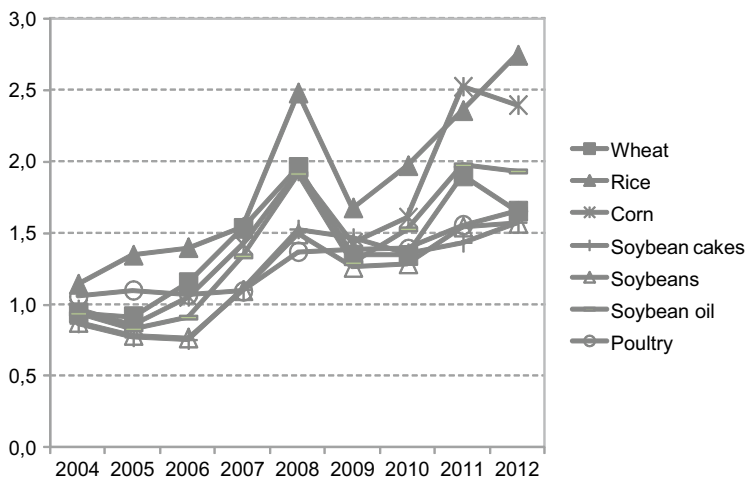
**Fig. 6.2** Food production in Cuba (indices, 1989=1.0). *Source:* Prepared by the author based on data from the National Statistics Office (ONE) (1998, 2006a, 2011)



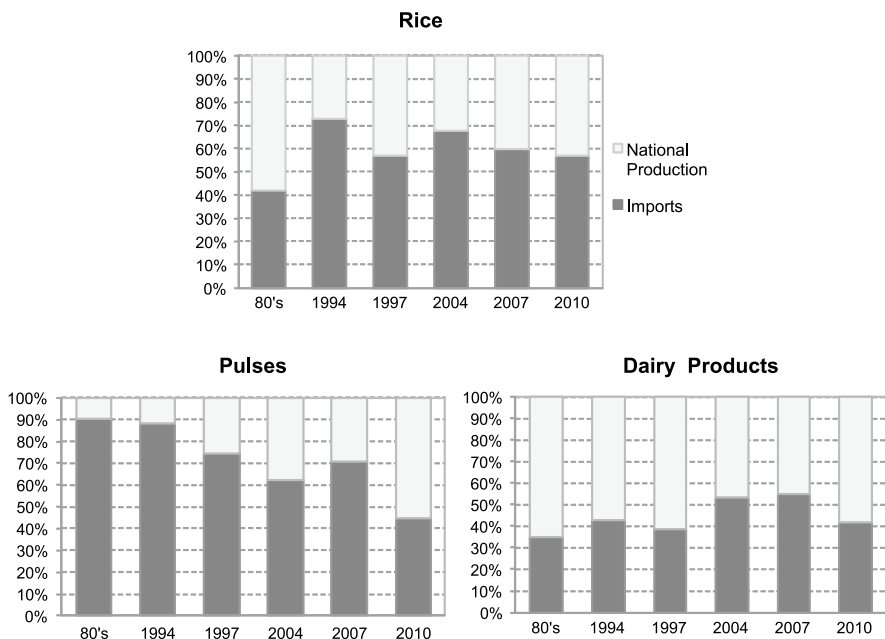
**Fig. 6.3** Cuban food imports as a share of total goods purchased. *Source:* Prepared by the author based on data from the National Statistics Office (1998, 2006a, 2011)



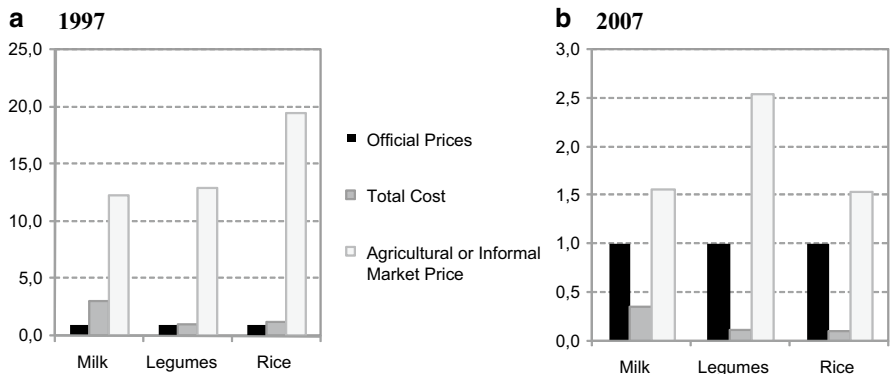
**Fig. 6.4** Product structure of Cuban food imports. *Source:* Prepared by the author based on data from the National Statistics Office (1998, 2006a, 2011)



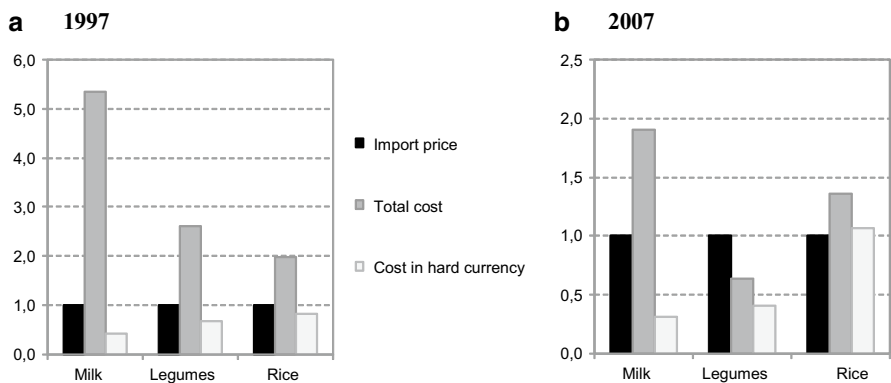
**Fig. 6.5** World prices of selected food products (Indices, Jan 2004 = 1.0). *Source:* Prepared by the author based on World Bank (2002–2013)



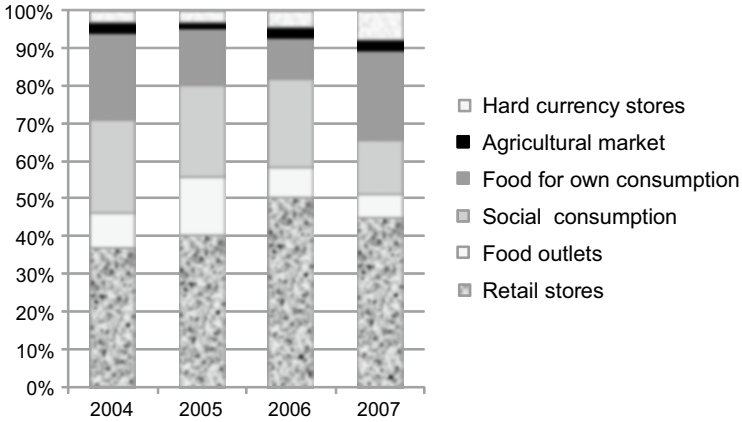
**Fig. 6.6** Sources of total supply in selected food products. *Source:* Prepared by the author based on CEE (1986, 1991), ONE (1998, 2006a, 2011)



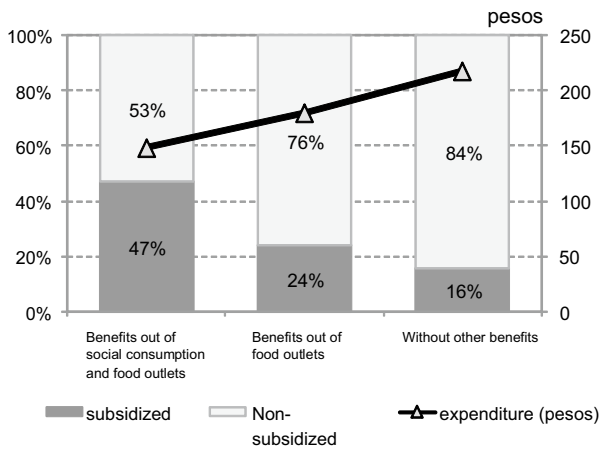
**Fig. 6.7** Estimated production costs, official prices and prices at the agricultural or informal market in Cuba for selected food products (indexes, official prices=1.0). *Source:* García (2009)



**Fig. 6.8** Estimated production costs, hard currency share of total costs and import prices in Cuba for selected food products (indexes, import price=1.0). *Source:* García (2009)



**Fig. 6.9** Consumption according to distribution sources in Cuba. *Source:* Prepared by the author based on ONE (2005, 2006b, 2007, 2009)



**Fig. 6.10** Per capita food expenditure for Cuban urban families and its composition according to access to subsidized sources, 2006. *Source:* García and Anaya (2009)

**Table 6.4** Results from the estimates of import demand functions of selected food-products in Cuba

*Long-term model*

$$LMQ_t = \beta_0 + \beta_1 LPNQ_t + \beta_2 LPRM_t + \beta_3 LPIB_t + u_t$$

where MQ: Imports in physical terms, PN: National production in physical terms, PIB: Gross Domestic Product, as proxy of the country's income, PRM: Import price, Letters L preceding each variable indicate they are expressed in logarithms

*Error correction model*

$$DLMQ_t = \mu_1 + \sum_{p=1}^0 \alpha_p DLMQ_{t-p} + \sum_{q=0}^0 \delta_q DLPNQ_{t-q} + \sum_{k=0}^k \theta_k DLPRM_{t-k} + \sum_{j=0}^j \eta_j DLPIB_{t-j} + \gamma_1 u_{t-1} + \varepsilon_{1t}$$

Letters D preceding each variable indicate they are expressed as first differences

	Powdered milk (80-06)		Beans (80-06)		Rice (80-06)		Fats (80-08)	
	Long term	Short term	Long term	Short term	Long term	Short term	Long term	Short term
LPNQ	-0.535	-0.863	0.182	Non significant	-0.516	-0.511 <sup>(a)</sup>	0.403	0.306
LPRM	Non significant	Non significant	Non significant	-0.749 (after 1994)	-1.246	-0.059 <sup>(a)</sup>	Non significant	-0.400 (after 1992)
LPIB	Non significant	Non significant	Non significant	Non significant	Non significant	0.923	1.022	2.100
$u_{t-1}$	-	-1.438	-	-1.168	-	-0.544	-	-1.271

**Table 6.5** Agricultural production 2004–2012 (1,000s of quintals)

Products	2004	2005	2006	2007	2008	2009	2010	2011	2012
Tubers and roots	31,738.4	26,559.0	23,817.5	24,283.5	23,361.8	25,596.6	25,014.0	24,400.9	24,105.3
<i>Specific types:</i>									
Potato	7,113.5	6,738.2	6,143.9	2,967.5	4,174.08	6,171.9	4,243.6	3,637.1	2,845.7
Sweet potato	10,567.8	7,168.1	–	–	–	11,652.6	–	–	–
Malanga	5,304.5	3,940.9	–	–	–	–	–	–	–
Plantain	18,023.3	12,657.0	14,339.5	18,083.2	13,039.65	10,650.4	11,941.7	14,009.2	15,400.6
Vegetables	53,677.3	42,926.2	37,963.0	36,729.7	34,401.3	36,907.9	31,070.8	32,696.9	31,394.7
<i>Specific types:</i>									
Tomato	10442.6	9193.7	8442.5	7522.0	7217.6	10356.9	6822.0	7928.5	7350.2
Pepper	1,202.0	1,053.1	901.0	873.9	845.6	793.5	623.9	797.8	923.9
Onion	1,902.3	1,850.5	1,623.7	1,580.4	1,591.3	1,630.5	1,387.0	1,780.5	1,467.4
Garlic	712.6	682.5	487.1	484.8	463.0	582.6	591.3	454.3	380.4
Rice (paddy rice)	10,628.6	7,991.6	9,439.5	9,556.0	9,478.6	12,252.6	9,878.6	10,000.0	11,178.7
Corn	6,537.8	5,344.5	5,085.4	5,774.1	4,984.9	4,469.7	4,956.7	5,411.0	5,508.9
Beans	1,722.7	1,295.3	974.0	1,191.3	952.2	1,313.1	954.3	1,584.8	1,515.2
Citrus	17,428.9	10,872.2	7,306.5	10,102.5	7,974.2	8,503.9	6,722.0	5,158.9	3,974.1
Fruit	10,659.0	8,683.5	8,488.0	8,715.5	8,689.4	8,411.3	8,595.9	9,232.9	10,898.2

1 metric ton = 21.74 quintals

Source: Prepared by author based on the *Anuario Estadístico de Cuba ONE 2005–2002* and Agricultural Sector. Selected Indicators February 2009–2012, ONE



Table 6.6 Livestock production 2004–2012

Unit of measure	2004	2005	2006	2007	2008	2009	2010	2011	2012
<i>Cattle</i>									
Slaughter	388.6	466.2	360.6	339.6	377.3	370.3	353.8	367.4	368.6
Liveweight	107.7	118.4	111.3	109.5	123.9	121.5	118.7	123.9	124.9
Average weight	277.2	254.0	308.5	322.3	328.4	328.1	335.4	337.2	338.8
Milk production	362.4	322.7	371.7	411.3	489.8	535.8	558.0	507.0	516.2
Milking cows	325.2	274.2	317.6	318.2	345.4	370.3	391.6	379.2	379.2
Liters/cow/day	3.05	3.22	3.20	3.5	3.9	4.0	3.9	3.7	3.7
Cattle stock	3,942.6	3,703.6	3,737.1	3,787.4	3,821.3	3,892.8	3,992.5	4,059.1	4,084.0
<i>Porcine</i>									
Slaughter	1,097.7	1,161.8	1,463.8	2,134.5	1,814.8	2,107.8	2,133.1	2,349.5	2,144.0
Liveweight	73.8	86.3	119.1	181.9	162.3	170.7	170.4	192.7	177.6
Average weight	67.2	74.3	81.4	85.2	89.4	81.0	79.9	82.0	82.8
Porcine stock	1,245.3	1,293.3	1,410.2	1,502.1	1,553.8	1,469.2	1,408.3	1,357.9	1,366.0
<i>Poultry</i>									
Egg production	1,405.2	1,727.1	1,913.2	1,983.7	1,883.0	1,931.9	1,924.0	2,028.1	1,954.3
Laying hens	1,186.3	1,494.6	1,718.8	1,760.9	1,704.3	1,693.6	1,708.2	1,775.6	1,729.0
Hen stock	4,490.3	5,711.7	7,042.8	7,315.9	7,271.1	7,100.0	7,010.2	7,206.0	7,366.4
Eggs/laying hen	264.2	261.7	244.1	240.7	234.4	239	243	246	235
Feed/10 eggs	1.5	1.5	1.6	1.6	1.7	1.6	1.6	1.6	1.6
Meat production (liveweight)	10.1	8.6	9.3	12.0	11.3	10.6	13.1	12.0	11.9

Source: Prepared by the author, based on the *Anuario Estadístico de Cuba ONE 2002–2010* and Agricultural Sector. Selected Indicators February 2009–2012

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# Chapter 7

## Cuba's *Apertura* to Small Enterprise

Archibald R.M. Ritter

### Introduction

When defining the features that ought to characterize the building of a new society, the classics of Marxist-Leninism—particularly Lenin—stated, among other things, that the State, on behalf of all the people, should keep the ownership over all the basic production means. We turned this precept into an absolute principle and almost all the country's economic activity started to be run by the State. The steps we have been taking and shall take towards broadening and relaxing self-employment are the result of profound meditations and analysis and we can assure you this time there will be no going back.

President Raul Castro, 2011

Almost from the beginning of the Cuban Revolution until 2010, official policy towards small enterprise first was to eliminate most of it in a variety of policy moves culminating in the “Revolutionary Offensive” of 1968 and from 1993 until 2010 to permit a limited but contained opening to the sector. Despite this negative policy environment, Cuba incidentally generated a significant reservoir of entrepreneurship that constitutes a valuable resource for the on-going and future emergence of the small enterprise sector.

In October 2010, a variety of liberalization measures were introduced, as a means of stimulating small enterprise enough to absorb large numbers of state sector workers that were considered redundant and were to be laid off. The new supportive approach to small enterprise was then ratified by the VI Congress of the Communist Party of Cuba in April, 2011. Because the small enterprise sector did not expand rapidly enough, further liberalizing steps were initiated in May 2011. The policy changes from 2010 to 2012 represent a major shift in Cuba's development trajectory. Already by 2012 the expansion of the sector has been dramatic—even if below the expected or planned levels.

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There now can be little or no doubt that this new expansionary course will be maintained in view of the failures of past policy approaches to the sector, the obvious benefits of the new policy approach and the demonstrated pragmatism of the Government of President Raul Castro. However, if Cuba is to obtain optimum benefits from small enterprise sector, a range of further reformist measures as well as some tax reforms are still necessary.

The objective of this essay is assess the policy environment in which the small enterprise sector operated as of mid-2012 and to explore some alternate policies and approaches towards the sector for the future. By way of introduction, however, the policy approach to the sector from roughly 1960 to 2010 as well as the impact of this policy environment on the shaping of entrepreneurship is outlined briefly.

## **Entrepreneurship: Cuba's Previously Suppressed Resource**

During the 30 years from around 1963 to 1993 in which the exercise of entrepreneurship in a market-oriented setting was largely prohibited, Cuba in fact created a nation of entrepreneurs. Although the intention was to convert Cuba into a "school for socialism," the reality is that Cuba has also been, in part, a school for market-oriented entrepreneurship. This is one of the more surprising paradoxes of the Cuban Revolution.

The nature of Cuba's planned economy itself inadvertently promoted widespread entrepreneurial values, attitudes, behavior, and *savoir-faire* as citizens of necessity had to buy and sell, truck and barter, hustle and "network" in order to improvise solutions to their personal economic problems. One important phenomenon in this process was the rationing system, implemented initially in 1961. This system was designed to provide everyone with a basic supply of foodstuffs, clothing, and household consumables, in order to achieve a minimum level of equality of consumption and real income. It provided every individual (or household for some products) with fixed monthly quotas of foodstuffs, cigarettes, or household consumables and with annual quotas for clothing and footwear. Everyone received the same allocations of products at controlled and generally low prices (in relation to average monthly incomes).<sup>1</sup> Because everyone received essentially the same rations, many people would receive some items that they did not want or which were of lower priority than other items. In the context of generalized shortage and excess demand which existed with varying intensities since 1962, especially after 1989, everyone had an incentive to sell the rationed items they did not want or to trade them for other products they did want. For example, nonsmokers would purchase their cigarettes and cigars through the rationing system and would then give them to other family members or friends, resell them on unofficial markets, or trade them for other products. Thus, the rationing system itself converted many people, regardless of their levels of ideological enthusiasm, into mini-capitalists, searching for opportunities to sell and to buy.

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<sup>1</sup>Children and those with special health problems such as diabetics were treated differently and provided with special food rations.

The situation of excess demand and generalized shortage, especially after about 1988 when the cessation of subsidization from the Soviet Union began to make itself felt, also meant that anyone with privileged access to a product at an official price could resell it at a higher free-market price or in the dollar economy. There was therefore a strong incentive for "rent-seeking" or making a profit from buying and selling or exchanging many types of product between the fixed-price official sources and the unofficial or "black market" determined price. Related to the above phenomenon was "*amiguismo*" or "*sociolismo*" or "partner-ism," that is, the reciprocal exchange of favors. While such reciprocity probably occurs in all countries and in many different contexts, it took on some important additional forms in Cuba. Basically, any person with control over resources could exchange access to those resources for some current or future personal material benefit. Cultivating friends or associates in this way was vital for assuring oneself and one's family access to the goods and services necessary for basic material well-being. Complex networks of reciprocal obligations thus became an important part of the functioning of the economy. Daily life involved continuing endeavors in maintaining the personal relationships necessary to ensure access to necessary goods and services through the underground economy, or through the official channels via reciprocal services or "tips."

In short, citizens in their everyday material lives had to behave in an entrepreneurial manner. At the level of the individual or more often the family, people had to explore continuously and evaluate new economic opportunities, to acquire the consumer goods they and their families needed, to sell some consumer goods (or in some cases outputs of goods and services), to bear uncertainty, face risk and take ultimate responsibility, and to invest in the maintenance of their supply and market networks, all under hard and unforgiving budget constraints.

A second area where entrepreneurial action was necessary was, paradoxically, in the central planning system itself. In a perfectly functioning planning system, enterprise managers would have little to do besides obeying and implementing orders. But because the planning system could not and cannot work perfectly especially in the face of continuing disruptions and uncertainty, enterprise managers often had to take initiatives in resolving unforeseen problems. Frequently, solutions to such problems were to be found outside the normal channels of the planning system and required improvised responses by the enterprise managers. This often involved enterprise managers obtaining the required inputs through negotiations with other enterprises, with superior officials, or with superiors or inferiors in other sectors or Ministries. In these negotiation processes, political argumentation, political or Party "*amiguismo*" or "*sociolismo*" (i.e., the exchange of favors within the Party for political and material benefit) as well as economic criteria were central, and economic management was therefore highly political. Managers throughout the Cuban economy had to invest large amounts of time and energy in resolving such input-supply problems. Indeed, their performance depended upon their entrepreneurial success in operating "outside the plan."

While entrepreneurial talents have been developed broadly among the population, their exercise until 1993 was for the most part restricted to the important but low-level everyday tasks of sustenance and survival, often carried out in the

underground economy or in “black markets.” But when the space available for entrepreneurial activity was increased with the liberalization of microenterprise beginning in September 1993, the expansion and diversification of micro-entrepreneurial activity was impressive.

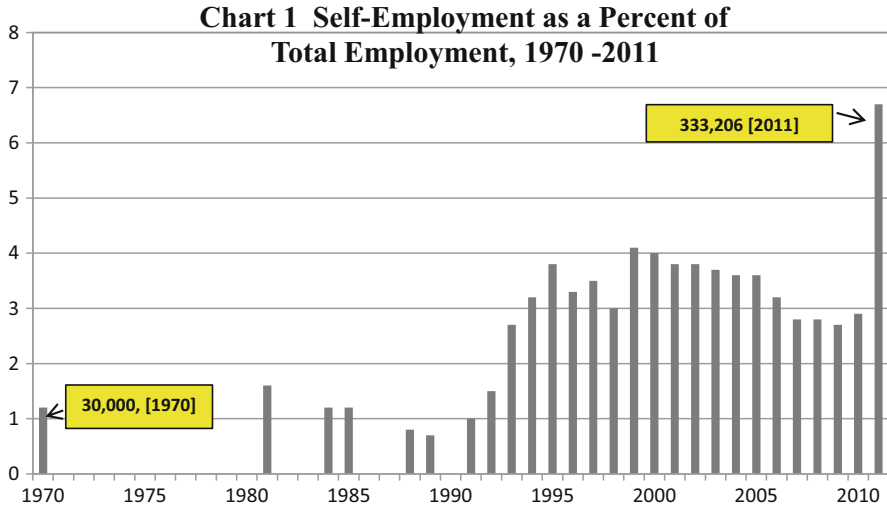
For example, when the production and sale of arts and crafts products mainly for a tourist market was liberalized, the production of such items sprang to life. Before this, the souvenirs and craft products available for purchase by tourists or Cuban citizens were of low quality and minimal diversity, coming as they did from a number of state workshops. However, by 1994, the Cathedral Square, Avenue “G” between 23rd Street and Linea, and La Rampa between “N” and “O” Streets were filled with vendors providing a rapidly widening range of crafts and arts. Very soon there were too many vendors for these locales and they were relocated to the Malecon, and the park between Avenida del Puerto and the Cathedral as well as La Rampa. In 2011, the Government provided a major new facility in a renovated port warehouse. Most tourists to Havana buy some mementos or souvenirs or in some cases major pieces of art generating significant amounts of foreign exchange for Cuba.

Similarly, the quasi-private restaurants in the Barrio Chino enjoyed a cultural exemption from the controls placed on normal “*paladares*” or restaurants facing no 12 chair limitation on their size. They emerged some time ago as dynamic, large, diverse, and efficient restaurants—among the best in Havana. They also have been a living example of what many sectors of the Cuban economy could become with softened regulations and more reasonable tax levels.

## **Public Policy and the Evolution of Micro-enterprise 1961 to 2010**

In the early years of the Government of President Fidel Castro, culminating in the Revolutionary Offensive of March 1968, most of the non-farm economy was expropriated and placed under the control of relevant Ministries and ultimately *Junta Central de Planificacion (Juceplan)*. By 1970, the number of officially recognized self-employed had fallen to around 30,000 or 1.2 % of the labor force (see Fig. 7.1) The official rationale for the nationalizations was to eliminate capitalism and the “chaos of the market” as much as was possible and replace these with the “rationality” of central planning.

The consequences of the nationalizations of small enterprise became quickly apparent. The state sector—controlled by bureaucracies in Havana office towers—was unable to replace small scale entrepreneurial efforts adequately so that quality, quantity and the diversity of production declined. The underground economy expanded, theft from the state sector increased in part to feed underground enterprises, and material standards of living were impaired. The urban landscape became commercially dead—in contrast to the bustle of other Latin American cities. The economy entered a long period of sclerosis, typified by the existence of the many of the same state-owned restaurants on *La Rampa* in 2011 as in 1970.



**Fig. 7.1** Self-employment as a percent of total employment, 1970–2011. *Source:* ONE *Anuario Estadístico de Cuba*, various issues, and Vidal Alejandro and Perez Villanueva 2012, p. 47

In response to the 1990–1993 economic melt-down arising from the cessation of Soviet subsidization, in October 1994 the government ratified what people were already doing as part of their survival strategies and legalized many new areas of self employment. As a result, self-employment expanded rapidly as enterprises sprang up from the underground economy and as new enterprises commenced. By 1995, there were some 138,000 registered micro-enterprises. This process led to major improvements in the quality, quantity and diversity of goods and services, to increased productive employment and income generation, to increased foreign exchange earnings and savings, to increased tax revenues, to renewed commercial vigor in urban areas and to a general improvement in the quality of people's lives. On the downside, because no provision made for the legal sale of inputs to the sector, a main source of inputs came to be theft from the state.

Much has been made of alleged high incomes in the micro-enterprise sector. Indeed, restaurants and bed and breakfast operations did generate high incomes for a while at least, and when there was a huge monetary overhang and excess money in circulation, prices and incomes were pushed to high levels. When the excess money in circulation was eliminated, prices in the microenterprise sector declined and incomes fell. Most of the sector involved and still involves low-income people providing goods and services for other low income people, so that in consequence, the micro-enterprise sector is a less significant source of income inequality.

Shortly after the legalization of self-employment, the government began to contain it with various limitations, controls, prohibitions, and onerous taxes. In most countries, formal or officially recognized micro-enterprises operate within a set of laws and regulations regarding labor standards, health and safety, product quality and the environment. Through their taxes, they bear a share of financing the



**Table 7.1** The self-employment licensing process, Havana, 1996–2001

Application process categories	Number of applications per year							
	1994	1995	1996	1997	1998	1999	2000	2001
Total applications for Licenses	248,552	390,759	46,268	69,407	84,456	91,398	94,827	97,687
Applications in process	4,193	21,963	n.a.	n.a.	n.a.	n.a.	n.a.	499
Licenses granted	169,098	208,786	38,057	34,984	31,587	28,380	24,719	23,351
Licenses granted as percentage of total applications	68.0 %	53.4 %	82.3 %	50.4 %	37.4 %	31.1 %	26.1 %	23.9 %
Applications refused	10,675	11,519	8,211	34,423	52,889	63,018	70,10	74,337
Withdrawn during application	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	11,332
Failed application process	64,586	148,491	1,791	24,990	41,002	50,015	56,809	60,627

Source: *Ministerio de Trabajo y Seguridad Social*, CEPAL (1997), and *Dirección Provincial de Trabajo y Seguridad Social*, 2001, p. 1 and 5

functioning of communities and public goods. In Cuba, however, the tax and regulatory environment was stringent and was designed to limit the incomes that can be earned in the sector, to restrict the size of the individual micro-enterprises, and to reduce the size of the self-employment sector in general.

The most powerful mechanism for limiting the size of the micro-enterprise sector was the license granting process—and the simple expedient of refusing to grant licenses to petitioners. Table 7.1 provides an idea of the limited licensing that was accepted for micro-enterprise in the latter 1990s. The acceptance rate for license applications for self-employment in Havana declined steadily in the first 8 years of legalization, reaching a low of 24 % in 2001.

Part of the legislative framework, extracted from Decree Law 174 passed in 1997, within which Cuban micro-enterprises had to operate together with the punishments for contraventions of the regulations is summarized in Table 7.2. The restrictiveness of the regime is readily apparent. Articles 3 and 5 in particular provide an idea of the flavor of the regulatory environment for self-employment activities. The punishments for infractions, determined by a large corps of inspectors were serious and involved termination of the relevant activity and confiscation of equipment as well as fines.

There was also an onerous tax regime against self-employed Cuban citizens. Of particular note was the 10 % limit on production costs that could be deducted from gross income in calculating net taxable income. Moreover, investment expenditures were not deductible from taxable income.

As a result of this containment approach, the sector ceased to expand and in fact diminished as a proportion of total employment after 1995 as illustrated in Fig. 7.1.

By 2006, when Raul Castro became Acting President following the illness of Fidel Castro, the inadequacies of the state sector in providing the basic goods and services for the population had become starkly apparent. This was manifested in the

**Table 7.2** Decree-law 174: Self-employment contraventions and punishments

Contravention	Fines <sup>a</sup> (Pesos)	Seizure of equipment	Withdrawal of License <sup>b</sup>
<i>Article 3 Contravention of Micro-enterprise Regulations</i>			
1. Exercise of unauthorized activity	500–1,500	Yes	Not relevant
2. Exercise of legal activity by unauthorized person	400–1,200	Yes	Not relevant
3. Violations of regulations in a legal activity			
(a) More than 12 places (seats) in a private restaurant	500–1,500	Yes	2 years minimum
(b) Sale of fish, seafood or beef in a private restaurant	500–1,500		
(c) Sales in \$US when not authorized	500–1,500		2 years* min
(d) Sale of alcohol without accompanying food sales	400–1,200		2 years* min
(e) Use of seats, benches or tables in street vending	500–1,500		2 years* min
(f) Use of other location than one's home	250–750	Yes	2 years* min
(g) Inadequate receipts for legal purchase of inputs	250–750		2 years* min
(h) Use of family labor without licenses	400–1,200	Yes	2 years* min
(i) Exhibiting unauthorized films in video rooms	400–1,200	Yes	2 years* min
(j) Sale or use of protected flora or fauna	400–1,200		1 years* min
4. Use of one's home for someone else's micro-enterprise	250–750		
5. Use of intermediaries or specialized sellers	400–1,200		1 years* min
6. Acting as an intermediary for other's products	400–1,200		2 years* min
7. Nonpayment of rental fee for market space	150–500		
8. Sales to state entity without specific permission	400–1,200		
9. Safety violations	400–1,200		
10. Hiding or falsifying information from authorities	400–1,200		
11. Failure to show registration documents at any time	400–1,200		
12. Employment of persons under 17 years	500–1,500	Yes	2 years* min
13. Acting as a wholesaler to other micro-enterprises	500–1,500	Yes	1 years* min
14. Sales or exhibition of legal products by sellers of other products	500–1,500	Yes	Permanent
15. Organization of producer coops or associations unless authorized	500–1,500		Permanent
16. Resale of industrial products purchased in state sector	400–1,200	Yes	
17. Use of prohibited materials or inputs	250–750	Yes	2 years* min
18. Operation in other provinces from that authorized	250–750	Yes	
19. Failure to update information provided to Registros de TCP	150–500		
<i>Article 4. Contravention of Micro-enterprise Sanitary Regulations</i>			
1. Noncompliance with Hygiene-sanitary Rules	500–1,500	Yes	
2. Inappropriate waste disposal	400–1,200		1 years* min

(continued)

**Table 7.2** (continued)

Contravention	Fines <sup>a</sup> (Pesos)	Seizure of equipment	Withdrawal of License <sup>b</sup>
3. Failure to show authorities the sanitary license	400–1,200		Perhaps 2 years* min
<i>Article 5. Contravention of Tax Provisions</i>			
1. Failure to make monthly or annual payments on time	50 % of taxes due		
2. Failure to register or provide new information	150–500		
3. Failure to show documentation of any time	150–500		
4. Failure to keep revenue and cost information for 1 year	250–750		
5. Failure to provide information in the required form	500–1,500		
6. Failure to permit free access to designated inspectors	400–1,200		
<i>Article 7. Unintentional Contraventions</i>			
Contraventions which are unintentional or made by those with favorable conduct	Fine partly or fully reduced		
<i>Article 8. Multiple Contraventions of multiple character</i>			
	Fines doubled		
<i>Article 9. Repeat Offenders</i>			
Offenders who repeat contravention twice in a 2 year period	Imposition of highest fine		2 years* min.

Source: Decreto-Ley No. 174, De las Contravenciones Personales de las Regulaciones del Trabajo por Cuenta Propia, Gaceta Oficial, Numero 22, 30 de Junio de 1997. pp. 337–352

<sup>a</sup>The average monthly income in Cuba was 214 pesos in 1996. The fines thus range from 70 to 700 % of the average monthly income, and higher for multiple offenses

<sup>b</sup>Some micro-entrepreneurs state that the minimum two-year suspension may really mean a permanent suspension

very limited amount of goods and services available through the ration book. Volumes of production of manufactured goods in 2006 had not recovered from the 1990–1993 melt-down and were only 43.6 % of the 1989 level (ONE 2010, Cuadro 11.1). Few products manufactured in Cuba were available in the “*moneda nacional*” economy. Instead only imported manufactures of many sorts including clothing, footwear, and household gadgetry were available and had to be purchased for “convertible pesos” in the “*Tiendas por la Recaudacion de Divisas*” (formerly the dollar stores). And the underground economy for wide ranges of goods and services was flourishing as never before.

After Raul Castro succeeded his brother, a number of policy innovations and experiments were introduced that seemed to suggest that major policy changes were being contemplated and analyzed within the Cuban government. These policy changes included

In 2006:

- Permission for Cuban citizens to enter and use hotel facilities.
- Relaxation of rules re purchase of electronic items.

In 2008:

- The elimination of the cigarette ration.

In 2009:

- Long-term leases (10 years) of unused state agricultural land by small farmers.

In 2010:

- Privatization of urban parking arrangements: parking attendants now paid a rental fee to the state for the right to allocate parking places on designated sections of streets, charge those parking their cars and retain a profit.
- Relaxation of some restrictions on private taxis.
- Experimentation with cooperative hair dressing salons and barber shops.
- Establishment of markets for inputs for small farmers aside from state input allocation.
- Permission for bus drivers to rent small city busses and operate them on a “for-profit” basis.

These were interesting if minor innovations. They were of a suggestive, tentative and experimental character rather than definitive.

## **President Raul Castro's Small Enterprise Policy Reforms, October 2010**

In October 2010, Raul Castro's Government introduced a broad set of policy reforms for small enterprise that was part of a broader reform package designed to shrink the state sector ultimately by firing 500,000 redundant workers by March 31, 2011 and ultimately 1.8 million workers in total by 2015 (Granma, 13 de Septiembre de 2010). These workers released from the downsizing of the state sector were to be reabsorbed into the non-state sector, including small enterprises and cooperatives. This was an amazing and ironic reversal of fortune for Cuba's private sector. Small enterprises had been almost eliminated in the 1960s, then liberalized from 1993 to 1995 and then were stigmatized and contained by onerous regulations and taxation. Now they were supposed to save the economy, generating jobs, higher productivity and higher living standards than was possible under the old system. Fidel Castro's 50-year attempt to construct his own varieties of “socialism” was being repudiated and abandoned by his own brother.

Firing 1.8 million state sector workers looked risky and brutal. Hoping that they would somehow be absorbed in the non-state enterprise sector looked like wishful thinking. In other contexts this approach would be labeled “neo-liberal” structural adjustment of the most draconian sort. Would the laid-off workers have the abilities

and aptitudes necessary to start their own businesses? But the biggest question was whether the small enterprise sector could create 500,000 jobs by March 30 2011 and ultimately 1.8 million new jobs.

### ***Regulatory Reforms***

The central features of the regulatory and tax reforms have been to liberalize the framework within which small enterprises operate and to accommodate the expansion of the sector, whereas the earlier regulatory and tax regimes from 1995 to 2010 were designed to contain its growth, to keep enterprises tiny, and to limit the incomes of the self-employed. The central features of the regulatory reforms can be summarized as follows:

- Licensing was broadened.
- Rental of facilities from citizens or the state became easier.
- Sales to state entities were now possible.
- Use of banking facilities and bank credit were slated to be introduced.
- Permitted activities were increased to a total of 181.
- Some regulations were eased, e.g., the 12 seat limit on the size of restaurants was raised to 20.
- Punishments for infractions of the regulations were eased. The seizure of equipment and the retraction of licenses have been dropped as punishments, but virtually all of the old infractions continue to be punished by the same fines as before.
- Imported inputs were slated to become accessible for small enterprise at wholesale prices.
- The activities of the small enterprise sector began to be “de-stigmatized.”

Of these, the liberalization of licensing was especially significant. Restrictions on the issue of permissions to establish micro-enterprises had placed a severe limit on the expansion of the sector. Reversing this policy then led to a rapid increase in the numbers of small enterprises.

However, some tight limitations on small enterprise remained. For example, professional activities continued to be prohibited. Intermediaries were still prohibited and each producer was supposed to be the seller of his or her output. Various petty restrictions such as the 20 chair rule continued. Tight limits continued on the hiring of employees. Advertising continued to be prohibited.

### ***Tax Reforms***

As part of the policy reforms designed to absorb the redundant state sector workers into the private sector, the Government of Cuba modified the micro-enterprise tax regimen. Some of the modifications were positive in the sense that they reduced the heavy tax burden on small enterprise. However, the changes were modest, and the tax system continues to limit job-creation and the expansion of micro-enterprise.

The new taxation system, presented in the *Republica de Cuba Gaceta Oficial, Número 11*, and *Gaceta Oficial, Número 12* on October 1 and 8, 2010, has four components: a Sales Tax; a tax on the hiring of workers; an income tax and social security or social insurance payments. Taxes generally are payable in *Moneda Nacional* or “old” pesos. For revenues or costs in convertible pesos (CUCs) they are to be translated into *Moneda Nacional* at the going quasi-official rate (around 22 to 26 “old” pesos per convertible peso, over the 2001–2010 period) for purposes of tax payment. There also is a special regimen for bed-and-breakfast operations that is not considered here.

First was a sales tax, a 10 % tax levied on the value of sales and payable by all micro-enterprises that do not qualify for the Simplified Tax Regime (See below.) While this tax in principle is certainly reasonable and is used in most countries, the administrative cost of monitoring the value of sales and collecting the tax for the many of the smaller self-employed activities will be high.

Second is a tax on the “Utilization of Labor.” This tax on the hiring of employees is set at “25 % of 150 %” (that is, 37.5 %) of the average national wage which was 429 pesos per month in 2009 (ONE, AEC 2010, Table 7.4). The tax would thus be about 161 pesos per month per employee or 1,932 pesos per year. A “Minimum” requirement for the hiring of employees for tax determination purposes was set at two employees for *paladares* and one for other food vendors and a few other activities. There appears to be no exception or adjustment of the tax for part-time employees. (Some 74 self-employment activities were prohibited from hiring employees and another seven could hire one employee only.)

Third, there are two income tax regimes: a simplified regime for smaller self-employment activities and a more complex regime for larger activities. The “Simplified Tax Regime” applies to some 91 activities. In place of the income tax and sales tax, they instead pay a consolidated tax, constituted by the monthly licensing fee which ranges from 40 to 150 pesos per month, payable in the first 10 days of each month. (It is unclear whether overpayments would be refunded—they were not under the previous system.)

Other enterprises fall under the general tax regime, and pay all of the individual taxes discussed here. These activities pay the up-front monthly tax/license ranging from 40 to 700 pesos per month. For the determination of the income tax payment, the “tax base” is defined as total revenue less a fixed amount for deductible expenses. The maximum amounts allowed for deductible expenses range from 10 % for 10 activities, 20 % for room rental operations, 25 % for 40 activities, 30 % for 10 activities and 40 % for 6 food and transport activities. (Bed and breakfast operations have their own specific regimen.) The tax rates rise progressively from 0 % for the first 5,000 pesos, through 25 % for additional income between 5,000 and 10,000, 30 % for income increments from 10,000 to 20,000, 30 % for 20,000 to 30,000, 40 % for 30,000 to 50,000 and 50 % for additional income exceeding 50,000.00 pesos. These rates are high but not unreasonable in international comparison.

Fourth are Social Security Payments destined ultimately for old age support, maternity leave, disability and death in the family. These are determined according to a scale that the self-employed worker selects, and may range from 25 % of 350 to 2,000 pesos per month depending on the choice of the self-employed person. This is a social insurance scheme though the payments are similar to taxes.

This new tax regime represents an improvement over the previous regime. The main improvement is that it permits the deduction as costs of production of more than a maximum of 10 % of total revenues as was the case previously. This is a reasonable adjustment to the tax base as most of the self-employed activities generate costs that are higher than the maximum allowable 10 % of total revenues. This is especially beneficial for activities such as gastronomic, transport and handy-craft or artisan activities for which input costs are far beyond 10 % of total revenues. The progressive structuring of the income tax regime is reasonable though stiff.

However there are a number of flaws in the taxation regimen which will continue to stunt the development of small enterprise and will prevent the absorption of the redundant workers being displaced from the public sector. First, the tax on employment adds to the employer's cost of hiring a worker so that it will limit hiring and job creation. Alternately, employment will be "under the table," unrecorded, and out of sight of officialdom. Second, the overall tax level is punitive. The sum of the income tax and employee hiring tax is high—and can help create effective tax rates exceeding 100 %, as is explained below.

The most serious shortcoming of the income tax regime involves the tax base which still is not "net revenues" after the deduction of input costs, but an arbitrary proportion of total revenues. The maximum for input costs deductible from total revenues is limited to 10–40 % depending on the type of enterprise involved. When the actual micro-enterprise input costs exceed the maximum allowable, the tax rate on true net income can become very high. In the example below, the effective tax rate (defined as the taxes payable as a percentage of true net income) can exceed 100 %. If this were to be implemented in such a case, it would kill the enterprise. In general, this provision will promote cheating and noncompliance. It will discourage underground economic activities from becoming legal and block the establishment of new enterprises.

Fourth, the reforms of the micro-enterprise tax regime do little to reduce the fiscal discrimination favoring foreign enterprise. The main difference is the determination of the effective tax base which is total revenues minus all costs of production for foreign firms. In contrast, for micro-enterprise the tax base is gross revenue minus arbitrary and limited allowable levels of input costs ranging from 10 to 40 % depending on the activity. The result of this is that the effective tax rates for foreign enterprises are reasonable. But for Cuban microenterprises the effective tax rate can be unreasonable and could reach and exceed 100 %. Moreover, investment costs are deductible from future income streams for foreign firms this being the normal international convention. But for Cuban micro-enterprise, investment costs are deductible only within the 10–40 % allowable cost deduction levels (Table 7.3).

### ***Example: Three Taxation Cases for a Paladar or Restaurant***

To illustrate the character of the tax regime, a case of a "Paladar" is examined below, with the calculations summarized in Table 7.4. In this example, it is assumed

**Table 7.3** Comparison of the new tax regimes for Cuban micro-enterprise and foreign enterprise operating in joint ventures

	Micro-enterprise sector	Joint ventures
Nominal tax rates	25 % rising to 50 % of gross income	30 % of net income [50 % for mining and petroleum]
Effective tax base	60–90 % of gross income; [Maximum of 10–40 % allowable deduction for input costs, depending on activity]	Net income after deduction of total production costs
Effective tax rates	May exceed 100 % of net income	30 % of net income [50 % for mining and petroleum]
Deductibility of investment	Deductible from taxable income only within the 10–40 % allowable deduction limits	Fully deductible from taxable income
Employee hiring tax	Tax of 37.5 % of average national wage for each employee hired	None
Social security payments	Yes	Yes
Lump-sum taxation	Up-front “Cuota Fija” tax payments necessary	None
Profit expatriation	No	Yes

Source: the author

**Table 7.4** Example: taxation calculation for restaurant, three cases (*Moneda Nacional* or CUP)

	Case A	Case B	Case C
Gross income	100,000	100,000	100,000
Actual input cost: percent of gross income	40 %	60 %	80 %
Peso value	40,000	60,000	80,000
Allowable costs deductible from gross income: %	40 %	40 %	40 %
Peso value	40,000	40,000	40,000
Actual net income before taxes (1–3)	60,000	40,000	20,000
Tax base: (1–6)	60,000	60,000	60,000
Income tax payable: (based on gross revenues less peso value of allowable costs deductible (1–5))	19,750	19,750	19,750
Minimum employee hiring tax: 2 employees at 37.5 % of average national wage per year	3,864	3,864	3,864
Total tax payment (8+9)	23,614	23,614	23,614
Real average tax rate: (10/6)	39.4 %	59.1 %	118.1 %

Assumptions:

Annual Gross Revenues: 100,000.00 CUP (280 CUP or about \$US 10.50 per day)

Actual Costs of Inputs (labor, rental, overheads, food purchases, investment etc.)

Case A: (40 % of total revenues) = 40,000 CUP

Case B: (60 % of total revenues) = 60,000 CUP

Case C: (80 % of total revenues) = 80,000 CUP

Source: The author, based on *Republica de Cuba Gaceta Oficial, número 11*, and *Gaceta Oficial, número 12* on October 1 and 8, 2010



that the total revenues or gross earnings of the *Paladar* are 100,000 pesos per year (Row 1) or a modest 280 CUP or about \$US 10.50 per day. It is imagined then that there are three costs of production cases: Case A, B and C where costs of production are 40 %, 60 and 80 % of total revenues respectively. A situation where input costs for a *Paladar* are 80 % of total revenues is reasonable, given the required purchases of food, labor, capital expenses, rent, public utilities, etc. On the other hand, the 40 % maximum is unreasonably low for many types of small enterprise.

The differing true input cost situations (Rows 2 and 3) generate different true net income (Row 6). The tax base however is determined by the legal maximum allowable of 40,000 (Row 4 and 5) and is 60,000 pesos in all three cases (Row 7). The income tax payable is determined by the progressively cascading scale noted above and is 19,750 in all three cases (Row 8, based on calculations not shown here). The tax on hiring the legal minimum two employees is 25 % of 150 % (that is, 37.5 %) of the average national wage which was 429 pesos per month or 161 pesos for 12 months for two employees or 3,864 pesos per year (Row 9). The total taxes then are the sum of Rows 8 and 9, or 23,614 per year (Row 10).

The effective tax rate is then calculated as the Tax Payment as a percentage of Actual Net Income (Row 10 divided by Row 6). For the Case “C,” where true costs of production are 80 % of total revenues, the effective tax rate turns out to be 118.1 %. Again, this is because the maximum allowable for costs in determining taxable income is fixed at 40 % of total revenues while the true costs of production were 80 % of total revenues.

The chief result of this example is that effective tax rates can be much higher than the nominal tax rates for all the activities where true input costs exceed the defined maximum. In some cases, taxes owed could easily exceed authentic net income—assuming full tax compliance. This situation likely occurs for all activities not covered by the simplified tax regime. Such high effective rates of taxation could destroy the relevant microenterprise and block the emergence of new enterprises which was the objective of policy prior to 2006. However, the objective of the new policy approach is to foster micro-enterprise and to create jobs.

### ***Further Steps in the Liberalization of the Regulatory and Tax Regimes for Small Enterprise, 2011–2012***

On May 27, 2011, Granma, the newspaper of the Central Committee of the Communist Party of Cuba, announced a number of additional measures that would reduce the restrictions on small enterprise. The objective of the policy changes was to facilitate the expansion of employment in the small enterprise, creating new jobs to absorb workers to be declared redundant in the state sector. The main policy modifications were as follows:

1. The hiring of up to five workers was extended to all self-employment activities. This is a significant change as it will encourage informally contracted assistants to be incorporated formally into many small enterprises.

2. Loss-making state enterprises such as state restaurants were to be offered for rental to self-employed individuals and operated as “*cuenta-propistas*.” This also may be a significant measure as it provides a mechanism for employment creation to take place at the same time as state sector workers might be declared redundant. In some cases, the same employees may end up working as a small enterprise or a perhaps as a co-operative.
3. *Paladares* or small restaurants were permitted to expand their capacity from 20 to 50 chairs—up from 12 before October 2010.
4. The “minimum employment requirement” whereby for purposes of paying a tax on each employee a minimum number of employees were required, was dropped.
5. An exemption on paying the tax on each employee was granted for the rest of 2011. This was a measure designed to provide start-up support for new enterprises.
6. Eleven new activities were designated for self-employment for a total of 181.
7. The payment of monthly taxes was waived for taxi and bed and breakfast operators for up to 3 months while they closed for repairs of their vehicles or rental facilities.
8. The monthly up-front payment for bed-and breakfast operators was reduced for the rest of 2011 from 200 to 150 pesos or convertible pesos (depending on whether they rented to Cubans in *Moneda Nacional* or foreigners in Convertible Pesos.) This also was an attempt to “jump-start” the formation of new enterprises, accelerating the establishment of new micro-enterprises and to provide a tax break while they commenced their operations.
9. The provision of micro-credits to the private sector from the banking system began in 2012. But only around 10 % of the credits went to small enterprise with the rest going to home repair (Vidal Alejandro 2012).

These changes are all reasonable. The government stated that it is “learning from experience” (“*rectificar en el camino*”). Pragmatism seems to be the growing vogue in economic management and that can only be positive.

By mid-2012, a number of additional policy innovations were under discussion or had begun to be implemented. Of special significance was the proposal to permit the establishment of employee-owned and operated cooperative enterprises to replace state enterprises in a large number of activities. This was to be implemented gradually. With experience gleaned from on-going pilot projects, a General Law of Cooperatives is to be introduced to provide the relevant legal framework. The conversion of a wide range of state enterprises in services and light manufacturing could turn out to be highly significant—or it may not, depending on the framework itself and how the law is implemented. Under such a framework, it is possible that professional services such as architects, accountancy, consulting of various sorts and computer services also could be organized—as many types of these services can operate in relatively small groupings.

One policy introduced in 2012 will have a negative impact on small enterprise. In the absence of wholesale markets for domestic and imported goods, some small-scale entrepreneurs came to rely on periodic imports of inputs brought to Cuba by

travelers by air from other countries.<sup>2</sup> The imposition of high rates of taxation on such imports will hurt many small enterprises. One hopes that provision will be made quickly for the establishment of wholesale markets for inputs.

## Evaluation of the Policy Modifications

Can the micro-enterprise sector generate about 1.8 new jobs million by the end of 2015? On the positive side, there have been some important measures:

1. The political and media stigmatization has been reversed.
2. The liberalization of licensing has opened small enterprise to all possible entrants. This measure will increase competition and push prices downwards and therefore incomes in the sector towards average levels. The increased competition also will be beneficial in terms of product quality, diversity and price.
3. There has been a small increase in permitted activities.
4. Some regulations have been relaxed.
5. The increase in employment to a maximum of five workers for any micro-enterprise will reduce the miniaturization of enterprises in the sector and permit greater economies of scale.
6. The increase in the deductibility of costs from gross revenues for taxes for some activities is beneficial.
7. Future access to micro-credits, to banking facilities and to the purchase of both domestic and imported inputs at wholesale prices are all promising though as of September 2012 not yet fully in operation.
8. The rental of state facilities to small entrepreneurs for their undertakings may stimulate the abandonment of small scale service activities and manufacturing activities by the state, leaving these to the social control exercised by competition under the market mechanism.
9. The elimination of the harshest punishments for infractions, namely revocation of license and confiscation of equipment is also an valuable measure even though almost all of the original infractions still exist and are punishable by the original fines.

However there are still some limits to the policy modifications that will not facilitate job creation.

1. The high level of taxes generally will limit enterprise creation and legalization and will continue to encourage the underground economy.
2. The tax on the hiring of employees will discourage the absorption of labor into micro-enterprise activity.

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<sup>2</sup>The author knows of one micro-enterprise the owner of which undertook a marriage of convenience with a foreigner which permitted frequent travel to that country, the main purpose of which was to purchase inputs needed for the fabrication of the products sold in the micro-enterprise.

3. Micro-enterprises will remain stunted by the high effective tax rates that are incurred when costs of production exceed the minimum deductible for tax determination purposes.
4. The tax discrimination favoring foreign firms in joint ventures over domestic micro-enterprises continues.
5. Narrow definition of legal activities will limit enterprise and job creation.
6. Exclusion of high-tech and professional activities blocks the development of knowledge-intensive enterprises and wastes the training of the Cuba's highly educated population; Innovation throughout the economy blocked.
7. Some restrictions and prohibitions remain.
8. Wholesale markets, access to imported inputs and to banking facilities had not yet been commenced as of September 2012.
9. Restrictions on hiring workers remain, albeit at a higher level than previously.

By mid-2012, the number of people in micro-enterprises appears to have reached 390,000 (Oxford Analytica, August 17, 2012) up from 333,206 in September 2011 (Vidal Alejandro and Perez Villanueva 2012). This was a major increase though well below the target. Of particular note, of the 17 % of micro-enterprises workers in mid-2011 or about 55,500 were from the state sector. Some 16 % were retirees. Another 67 % had not been in the labor force, but presumably were housewives, in the underground economy, students entering the job market for the first time, or perhaps out of the labor force on disability pensions. The relatively small number of micro-enterprises formed by former state sector workers suggests that absorbing redundant state sector workers into micro-enterprise will not be easy, though the movement towards cooperatives will be helpful.<sup>3</sup>

## Conclusion

While the task of modifying the policy framework for the micro-enterprise sector is incomplete, major improvements have been instituted so far and more are in the process of implementation. In the summary presented in Table 7.5, it can be seen that major advances have been made in a number of areas, notably licensing and “de-stigmatizing.” Progress has been made or promised in a number of areas. There has been no action in a couple of areas that are relevant for the Cuban case. In still other areas, some reforms have been introduced but further action is desirable.

There are always disadvantages as well as advantages in economics and in the evaluation of public policy. I have trouble finding any disadvantages or costs in a liberalized policy environment for small enterprise. However, there are three concerns that should be addressed.

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<sup>3</sup>By economic activity, some 16 % people in the small enterprise sector were in transportation, 20 % were in gastronomic services (restaurants and street vendors,) 5 % rented rooms, and some 10 % were employees working in the small enterprises (Vidal and Perez Villanueva 2012, p. 47).

**Table 7.5** Major public policy areas for micro-enterprises

Policy area	Status
Liberalize licensing: let anyone and everyone open a small enterprise	Done
Permit all types of self-employment, including professional and high-tech	Not yet
Taxation regime	Needs work
Raise the limit on employees to 10 or 20	In process
Provide wholesale markets inputs	In process
Permit access to imported inputs (outside TRDs and at the exchange rate available for the state sector)	In process
Eliminate silly and vexatious restrictions	Work needed
Establish Micro-credit Institutions	In process
Legalize “intermediaries” (permitting specialization between producers and vendors)	Not yet
Permit advertising	Not yet
Legalize markets for housing, automobiles, and durables	In process
Cease the media and political campaigns against small enterprise	Done
Establish a “Ministry for Small Enterprise”	Not yet
Build the Credibility of Public Policy	In process

*Source:* the author

First, would such an *apertura* worsen income distribution? In the early stages, as some small enterprises increased in size, this would perhaps occur. But Cuba already has an income tax and an effective administrative system for taxing small enterprise so that this effect could be managed. Opening self-employment and small enterprise to all possible entrants would also increase competition in the sector and would push prices and thence incomes downwards towards average levels.

Second, would an *apertura* encourage pilferage of inputs from the state sector—as has happened in the past? This is a possibility that has to be managed. It can be managed by establishing a market for inputs for the sector that is reasonable and fair. In the past it was difficult for small enterprises to obtain their necessary domestically produced or imported inputs—except at the *Tiendas para la recaudacion de Divisas* (TRDs)—leading to purchases of inputs that were pilfered from the state sector. A reasonable market for the provision of inputs to the sector is thus vital.

Third, would an *apertura* lead to an expansion of “infractions” and illegalities as small enterprises tried to evade rules and taxes? This could indeed occur if regulations remained unreasonable and if tax burdens were impossible. If an *apertura* for small enterprise were accompanied by the dropping of vexatious regulations and if the tax regime was made reasonable, it is likely that compliance would improve. But building a culture of respect for regulations and taxes will also take time as the self-employed have come to view government as an enemy force imposing regulations that are aimed not just at their containment but also their elimination.

The economic reform process as it concerns the *apertura* towards small enterprise has been launched. It is in its early stages. It will likely continue under the more pragmatic leadership of President Raúl Castro who insisted (2011) that “there will be no going back.” It will proceed far beyond the “Lineamientos” under new generations of Cuban citizens in economic spheres generally.

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# Chapter 8

## Innovation, Entrepreneurship, and SMEs: What Can Cuba Learn from the Vietnam Reform Process?

Claes Brundenius and Doanh Le Dang

### Introduction

“After the war, Havana sent hundreds of technicians, including advisors specializing in tilapia fish farming and coffee production (to Vietnam). Paradoxically, today Vietnam exports \$2 billion USD worth of tilapia and also sells coffee, while Cuba has to import it.”

The above is a comment by President Raul Castro during his visit to Vietnam in July 2012 (Havana Times, 4 July 2012). Clearly, the most important reason for this paradox lies in the fact that the economic reform process in Vietnam started already in 1986, at the Sixth Congress of the Communist Party of Vietnam. Only in April 2011, that is 25 years later, did the Communist Party of Cuba celebrate its Sixth Congress (an interesting parallel), initiating an economic reform process that could learn a lot from the Vietnamese experience.

We will in this chapter briefly present and discuss the reform process in Vietnam, often referred to as *doi moi* (that means “renovation,” but also “innovation,” which sometimes creates confusion in translations) with respect to the conditions created for a healthy non-state sector, and the transition to a market economy and integration in the global economy. We will especially look at the regulation and implementation of the laws that were passed in order to stimulate the growth of non-state SME sector in Vietnam. We will then discuss these experiences in relation to the challenges confronting Cuba in its current reform process.

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## Similarities and Differences Between Cuba and Vietnam

The Vietnamese reform process is an interesting case of reference for Cuba in many ways. Both countries were following very similar “socialist models” for several decades. These models were typically based on Soviet inspired centrally planning. In both countries stagnation and systemic fatigue of the socialist model, coupled with mounting pressures against resources, led—eventually—to long overdue reform processes.

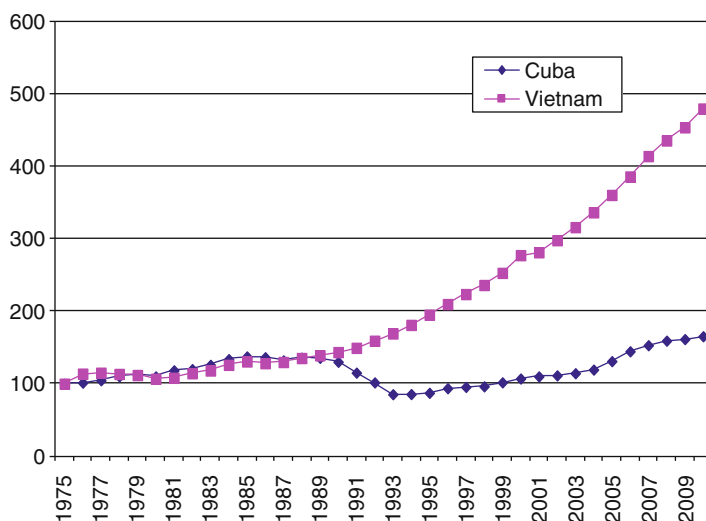
There are similarities between the reform process in Vietnam and the current reform process in Cuba, as will be discussed later, but there also important differences when we consider the conditions, not least structural differences (Table 8.1).

Vietnam experienced slow growth, in some periods even stagnation, between 1975 and 1985 (see Fig. 8.1 below). Cuba had a short period of reasonable high

**Table 8.1** Important structural differences between Cuba and Vietnam

	Cuba 2010	Vietnam 2010
Population	11.3 million	87.8 million
Urbanization	75.3 %	25.5 %
Labor Force	100.0 %	100.0 %
Primary sector	19.2 %	52.9 %
Secondary sector	16.3 %	20.4 %
Tertiary sector	64.5 %	26.7 %
GDP per capita (PPP)	9,900	3,400
Sector shares of GDP	100.0 %	100.0 %
Primary sector	4.3 %	35.1 %
Secondary sector	22.2 %	30.3 %
Tertiary sector	67.5 %	34.6 %

*Source:* ONE 2012 and GSO 2011; GDP per capita (PPP) data from Index Mundi (2012)



**Fig. 8.1** GDP growth in Cuba and Vietnam 1975–2010 (1975=100)



growth between 1975 and 1985 but then the economy went through a period of stagnation until it virtually collapsed after the demise of the Soviet bloc in the 1990s. By contrast, the Vietnamese economy accelerated at an unprecedented high rate after 1990, with exception for a short period in the aftermath of the Asian financial crisis (1997).

There are of course also other differences. One obstacle for Cuba has been the US embargo that have obstructed development options in Cuba for more than 50 years. On the other hand Cuba has not suffered from a long war with the same enemy.

## **The Economic Situation and Ownership in Vietnam Before *Doi Moi***

The private sector was very small in Vietnam before the reform process (“Doi Moi”) started in Vietnam in 1986. It primarily consisted of *households* in the agricultural sector. Most of agriculture was organized as cooperatives and state farms. In 1957–1958 the North Vietnamese government in a campaign against private ownership took over most firms in manufacturing and services, excluding micro business, such as rickshaw drivers, small eateries serving traditional *pho* (noodle soup). Most of the takeovers by the state were expropriations whereby the state paid a lump sum to the previous owner(s). These new firms often started as state-private joint ventures but in 1964 most of these were transformed into SOEs, while some remained as state-private joint companies. All agricultural farms in agriculture were transformed into cooperatives. Most of small handicraft and services were also reorganized as cooperatives (rickshaw drivers, small textile producers, etc.) operating within the framework of a centrally planning economy.

As a basically agricultural economy, the collectivization campaigns had a negative impact on socio-economic development. The share of state ownership increased from 17.9 % in 1957 to 44.6 % in 1965. The share of the cooperatives increased from 0.2 % in 1957 to 45.4 % in 1965, while the share of the private sector declined from 71.9 % in 1957 to 10 % in 1965 (see Table 8.2). Interestingly, there was at about the same time a similar collectivization campaign in Cuba, the “Revolutionary Offensive” in 1968.

However, the socialization campaign in Vietnam was not conducted any further. Small private agricultural activities were allowed on 5 % of the land for members of the cooperatives. This was one of the major income sources for the members of the cooperatives. Also, the farmers could sell products from this 5 % of land to the market and could earn 40 % of their income in the form of cash. The efficiency of this 5 % land was much higher compared with the 95 % collectively cultivated land of the cooperatives, and such facts worried government economists and policy makers. A system of state procurement of crops and meat at fixed prices caused de-facto losses for the farmers. The incentives system for the farmers was distorted. In the cities, small traders were morally condemned, administratively pursued, but they did not totally disappear since they to some extent satisfied people’s demands, which were neglected by the centrally planning and the rationing system. The supply

**Table 8.2** Ownership structure in North Vietnam, 1957–1975 (%)

	Socialized sector			Private sector
	Total	State owned	Cooperatives	
1957	18.1	17.9	0.2	71.9
1960	66.4	37.8	28.6	33.6
1965	90.0	44.6	45.4	10.0
1970	91.4	40.3	51.1	8.6
1975	91.6	51.7	39.9	8.4

Source: Tran van Tho et al. (2000)

**Table 8.3** Ownership structure in Reunited Vietnam, 1976–1985 (%)

Year	State-owned sector	Non-state sector
1976	27.7	72.3
1980	19.8	80.2
1985	28.0	72.0
1990	31.8	68.2
1995	40.2	59.8

Source: Tran Van Tho et al. (2000)

system in urban regions to fixed prices (lower than market price) on food and essential consumer goods caused artificially high demand in a shortage economy, as people tried to buy as much as possible in the fear that the goods would not be available in the future.

After reunification the country on 30 April 1975, when the US armed forces were finally defeated, two major campaigns of socialist reconstruction were launched in 1976 and 1978, respectively, in the South of Vietnam. All 22,456 private enterprises, employing 250,000 workers, among these 8,000 industrial enterprises, with a total capital of US\$ 800 million, were socialized (either through expropriation or confiscation). Thereby the share of the state-owned sector steadily increased as shown in Table 8.3. By the end of 1985, the socialist reconstruction of all Vietnam was declared to have been successfully completed.

Private capitalist enterprises were considered illegal and anti-socialist. The centrally planning system did not allow the operation of any private enterprise outside of the planning system. No materials were allocated, no credits were provided to private enterprises, if they existed. Manual work was praised in contrast to intellectual activities and professional services that were seen as non-productive. In such systemic economic, social, political and moral context, the capitalist elements could not exist. The society was asked to work hard, restrain from consumption and endure economic hardship and shortages with the vision of a brighter and more prosperous future.

## Doi Moi and Enterprise Reform in Vietnam

In 1983, the Hanoi Party Committee and the Peoples Committee still launched a campaign Z30 called “administrative control and inspection,” which appropriated asset and houses of more than 50 successful private enterprises, including the

well-known fish restaurant Cha Ca La Vong and the producer of rickshaw tires, the so-called king of tires. After the “doi moi” (see below), the appropriated goods were partially returned to owners, but such campaigns have created deep and bitter memories in the mind of the private entrepreneurs. Until the reform process started a large part of the ownership consisted of cooperatives, especially in agriculture. In 1986 no less than 72 % of the total labor force in Vietnam was employed in cooperatives (McCarty 2001).

Hopes that the use of the expropriated, or confiscated, machinery together with the collectivized land would lead to higher efficiency and productivity did not materialize. Lacking know-how, management skills, and incentives, production started to decline, and efficiency was low. The inefficiency of the system, the failures in economic policies and, last but not least, the gradual collapse of the Soviet Union contributed to the economic crisis in the 1980s.

However, already the Sixth Plenum of the Central Committee of the CPV (Communist Party of Vietnam) in 1979, had seen the beginning of microeconomic reform in Vietnam. Farmers as well as SOEs had attempted to finding ways of escaping from the rigidity of the economic system. The farmers tacitly experimented (and later were allowed) to apply the “contract system,” a de-facto allocation of arable land to the farmers for cultivation. The SOEs initiated “the fence-breaking” movement, a “three part-plan,” which enabled them to have more financial resources, and allowed them to buy and sell their products at market prices. In 1981 the Government legalized the “three part plan” of the SOEs (Resolution 25/CP and 26/CP). Furthermore, through a Directive in January the same year the Secretariat of the Central Committee of the Communist Party gave its blessing to the “contract system” in agriculture. In Long An province, an experiment to abolish the dual price system and introducing market prices had brought about positive results. A stormy debate broke out place in the party, voicing strong criticism of “the bureaucratic central planning system” as well as the voluntaristic attempts to eliminate the private sector and collectivize the farmers.

## **The Turning Point: The Sixth Communist Party Congress**

The Sixth National Congress of the CPV that was held in December 1986 proved to be an important turning point in changing the economic mindset of the CPV. At the time the country was confronted with a severe crisis. In spite of price control on essential goods and services the inflation rate was more than 700 %. Exports amounted to only USD 500 million while imports to over USD 1.2 billion, leaving a widening trade deficit. The Government was also faced with huge budget deficits as a result of feeding a large army and subsidies to loss making State Owned Enterprises (SOEs).

The reform program (Doi Moi), adopted at the Sixth Party Congress initiated a step-by-step liberalization of the private sector that was primarily induced by the practical needs of the daily life, and less from theoretical rethinking. Reforms in agriculture were so impressive that other measures were introduced to accept the

operation of the private sector in other fields. In 1988, the Government promulgated two Ordinances, opening up for private business to operate in industries, construction and transport (Ronnås & Sjöberg 1990). During the next 2 years, with mounting pressures against resources, the Government undertook bold, unprecedented and extraordinary measures, for instance allowing individuals to trade with gold and jewels, and as a result the price of gold was quickly normalized. Private housing construction was also allowed in 1989, which helped to ease the housing crisis. Private traders in retail trade, including rice retail trade, were also accepted. These measures produced such positive results that the Government decided to prepare a company law to be presented to the National Assembly in December 1990 to legalize the private sector.

## **The Enterprise Law of 1990**

The initial draft, prepared by CIEM (Central Institute of Economic Management), tried to adapt the Company Law of South Vietnam before 1975 with more than 300 articles. But several deputies of the National Assembly were unfamiliar with the market economy as well as with the practice of joint-stock companies, or company with limited liabilities. They therefore rejected the draft on the ground that it was too complicated and instead decided to promulgate a very simple law with only 34 articles, abolishing all details on internal company regulations. They also followed the French system of authorization of the establishment of company, requesting chartered capital for different industries and services. They split the law into two separate laws: (1) Company law for joint-stock company and company with limited liabilities, and (2) Law on private enterprise with unlimited liabilities. Regardless of some constraints, the promulgation of a Company Law at the very beginning of the reform was a bold and positive step toward market economy and the development of a private sector. In fact, from 1991 until 1999, some 45,000 private companies and enterprises were established, signaling an emerging new private sector in Vietnam.

## **The Drafting and Promulgation Process**

The Resolution of the Fourth Plenum of the Central Committee of the CPV on 28 December 1997 decided that a new law on companies should be prepared. However, even the 28th draft of the Law, presented to the National Assembly's Committee of Economic and Budgetary Affairs for pre-review, comprised different types of companies, including company with limited liabilities with one person as owner, company with limited liabilities with a legal person as owner and private enterprises with unlimited liabilities. This was confusing for the committee which could not differentiate between the different types of enterprise and therefore decided to take this chapter out of the draft. Argumentation and explanation by the drafting committee could not reverse the decision.

At last the Politburo of the Central Committee of the CPV discussed the draft of the Law based on the presentation by the Government and the comments by the National Assembly, and finally the Enterprise Law was approved (Enterprise Law 1990). During at times stormy, critical and open debates in the plenary session of the National Assembly, lasting several days, one article after the other was passed. Many amendments and corrections were made. The Chapter on the Partnership Company was debated with much doubts and concerns. The idea that practicing lawyers, medical doctors, or constructors, could bear unlimited liabilities for their works, was unfamiliar to most of the deputies. During the debate there was a time where the chance of keeping this chapter in the Law was very slim. At last, the Chapter was accepted with major changes, only with four articles with general provisions and no more regulation on unlimited liabilities. On 29 May 1999, the National Assembly passed the Law by majority vote (84.5 %).

## The Enterprise Law of 1999

The main idea of the Enterprise Law (EL) was as the name indicates to provide the legal framework for *all types of enterprises*. In reality there were already the Law on State-Owned Enterprises and the Law on Cooperatives. Foreign Directly Invested Enterprises were regulated by the Law on Foreign Direct Investment.

Article 2 of the Enterprise Law regulates the relation between this Enterprise Law with other specialized laws and “where a difference exists on the same issue between this law and a specialized law, the provisions of the specialized law shall apply.” Article 4 provides guarantees for enterprises and their owners: “the lawful assets and investment capital of enterprises and their owners shall not be nationalized or expropriated by administrative measures.” Such guarantees were required as a legal protection for private business during the drafting process.

Article 6 was important for implementing the freedom to do business with a legal framework. It said: “as prescribed by law, an enterprise may autonomously register and conduct lines of business other than those stipulated in Clauses 2, 3 and 4 of this Article.” Clause 2 stipulated the prohibited lines of business. Clauses 3 and 4 stipulated that: “Where a law, an ordinance or a decree, prescribes conditions for conduct of line of business, an enterprise may only conduct such line of business if it satisfies all the prescribed conditions” and “where a law, an ordinance or a decree requires an amount of legal capital, or a practicing certificate, for a line of business, an enterprise may only register such line of business if it has sufficient capital or a practicing certificate as required by law.” This article was important since it automatically canceled all the numerous permits, licenses or certificates that had been required by the ministers or chairmen of the Peoples Committee. However, since nobody knew exactly what licenses existed, the implementation of this article was not easy.

Article 9 stipulated clearly the rights to establish and manage enterprises. It stated that “Organizations and individuals have the right to establish and manage enterprises, except for the following cases.” Article 6 used the “Negative list” to

exclude state officials and others to establish and manage enterprises. Article 10 regulated the rights to contribute capital, allowing a larger circle of people, including foreign organizations and others to contribute capital. In the same direction, Article 12 stipulated: “The business registration body is not entitled to request the founder of an enterprise to submit additional documents other than those prescribed by this Law for each type of enterprises.” For the first time, a law had stipulated a clear restriction of the rights of a state agency. In that way the *prior registration checking*, exercised by the previous Company Law was replaced by the *post registration monitoring, internal control and the openness and transparency*. More importantly, it rigorously implemented the freedom to do business according to laws, doing away with the requirement to get the Decision of the Chairman of the Peoples Committee of the provincial level. In that way the red tape and abuse of power was put to an end.

Article 20 and 21 stipulated the provision of information on business registration and publication of the business registration. It aimed to introduce the transparency of the business registration and provide interested people with access to this information. The Law required the enterprises to “declare and periodically report fully and accurately all information regarding the enterprise and its financial situation.”

On the one hand, the intention of the Law was to implement the freedom to do business according to laws. On the other hand, the Law emphasized the internal control of the shareholders and obligations to creditors, mass media, and other interested parties, and last but not least, the efficient governance of the state agencies. In that way, the freedom to do business should not lead to chaos and arbitrariness, as some had argued would happen during the whole process of drafting and promulgation of the Enterprise Law. Chapter VII included articles about the reorganization, dissolution and bankruptcy of enterprises, opening up different ways to move from one type of enterprise to another, to mergers and acquisitions.

## **The Implementation of the Law**

Fully aware of the difficulties and obstacles emerging by the implementation the Prime Minister, for the first time, established a Task Force to assist him.

One of the most important contributions of the Task Force was the revealing and stunning studies on required licenses and permits for doing business. As mentioned before, Article 6 of the Enterprise Law automatically canceled all licenses and permits, issued by ministries and provinces. But these permits have to be explicitly canceled so that the enterprises do not need to observe these regulations. Responding to a request by the Task Force about permits and licenses, all ministries and state agencies ensured that they do not require any special permits or licenses. But a survey by the Task Force on licenses and permits showed that at least 402 different kinds of permits and licenses existed. After a process of long and difficult negotiations with the related ministries and agencies, the Prime Minister and the Government abolished altogether 180 licenses and permits. This tremendously reduced the costs in term of time and money to do business for the enterprises.

The Task Force has consistently and openly cooperated with mass media. Journalists have been invited to attend the meetings of the Task Force. The press has frequently reported about the implementation of the Enterprise Law. Vietnamese television (VTV1) has also organized several round table discussions between ministries and the business community on issues related to the implementation of the Law. The press has also raised the voice of the business community on shortcomings during the implementation of the Enterprise Law and has in that way provided the public and the Task Force with information about the emerging issues.

The Enterprise Law of 1999 was favorably received by the public. From 1 January 2000 to the end of February 2004, more than 88,264 newly established enterprises were registered. The number of joint-stock companies increased by ten times, compared to the total registered joint-stock companies in the previous nine years. Unlike foreign direct investment, which concentrated in a few more developed provinces, private domestic investment reached out to all 64 provinces. These enterprises created 1.6–2 million new jobs or equivalent to 90 % of the total newly created employment. The newly emerging non-state sector has turned out to be an important factor in reducing unemployment and poverty. The private sector, including the micro-household enterprises, account for 48 % of total non-oil exports, such as seafood, handicrafts, furniture but also garment and consumer electronics. All software and computer companies operating in Vietnam are private or joint-stock companies. The private sector contributes 7 % of the total budget revenues and has experienced an annual growth rate of 13 %. A new generation of primarily young entrepreneurs is emerging.

## **The Enterprise Law of 2005**

Up until 2005 Vietnam continued to have separate laws for private enterprises and SOEs. In order to comply with WTO commitments Vietnam promulgated a new Enterprise Law in 2005, replacing the Enterprise Law of 1999 incorporating SOEs in the new law. SOEs can now take the form of sole owner, joint stock company (jointly or without private partners), or conglomerates (see further below). The new Enterprise Law stated clearly that “(t)he State recognizes the long lasting existence and development of all types of enterprises as governed in this Law, ensures equality of enterprises before laws, regardless of ownership and component and recognizes the lawful profitability of business activities” (Article 5, Enterprise Law 2005). Through this Law it was expected that there would be no more discrimination between SOEs and the non-state sector.

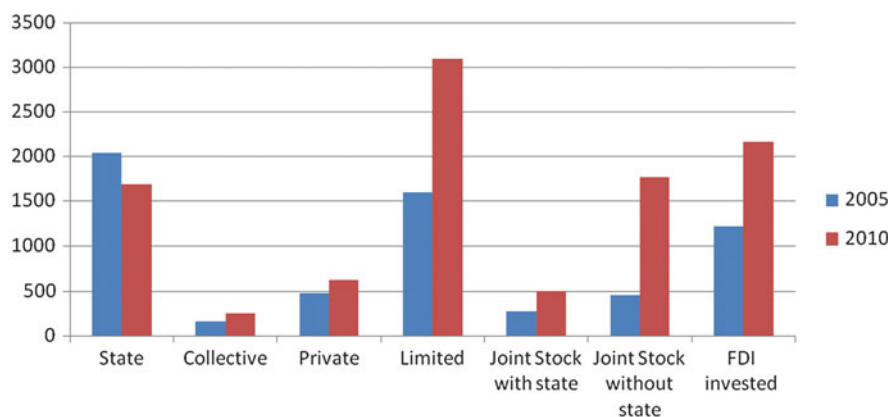
There have been important changes in the types of ownership registrations after January 2000. The share of companies registered as private (one owner) companies fell from 64 % of the total before the Enterprise Law to 34 % in 2004. Joint stock companies on the other hand increased their share dramatically over the same period, from 1.1 to 10 %. In absolute numbers, about 7,000 joint stock companies had been registered by 2004—nearly ten times the number registered over the previous nine years.



**Table 8.4** Vietnam: number of active enterprises on 31 December in 2005 and 2010

	2005		2010	
	Number	Percent	Number	Percent
Total	112,950	100.0	291,299	100.0
State	4,086	3.6	3,283	1.1
Non-state	105,167	93.1	280,762	96.4
Collective	6,371	5.6	12,003	4.1
Private	34,646	30.7	48,009	16.5
Limited	52,505	46.5	163,980	56.3
Joint stock (with state)	1,096	1.0	1,712	0.6
Joint stock (without state)	10,549	9.3	55,058	18.9
FDI	3,697	3.3	7,254	2.5

Source: Statistical year of Vietnam 2011 (Table 94)



**Fig. 8.2** Vietnam: number of employees in active enterprises in 2005 and 2010 (thousand).  
Source: Statistical Yearbook of Vietnam 2011 (GSO 2012), Table 97

The Enterprise Law of 2005 gave an additional boost to the establishment of private companies. Besides the Enterprise Law, other reforms like trade liberalization and the improvement of technical infrastructure also contributed to this development. After the adoption of the Enterprise Law 2005 the expansion of the private sector increased rapidly. The number of private (one owner) companies increased from 35,000 in 2005 to 48,000 in 2010 (Table 8.4). The number of companies with limited liability increased from 52,500 to 164,000 in the same period, and the number of joint stock companies (without state capital) from 10,500 to 55,000. At the same time the number of Foreign Direct Invested enterprises almost doubled from 3,697 to 7,254.

The private sector has been particularly important for employment creation (Fig. 8.2). Between 2005 and 2010 non-state sector employment more than doubled from 2,980,000 to 6,235,000. At the same time state employment decreased from 2,038,000 to 1,689,000. It is in particular small companies with limited liability that have increased. These companies accounted for 46 % of the increase in non-state employment. In terms of shares, total non-state employment increased from 47.8 %



**Table 8.5** GDP structure and growth by type of ownership in Vietnam 1995–2011

	Share of GDP (1994 prices)			Annual growth rates	
	1995	2005	2011	2005/1995	2011/2005
GDP (b. dong)	195,568	393,031	584,073	7.2	6.8
Percent	100.0	100.0	100.0	–	–
State	40.0	40.7	36.5	7.4	4.9
Non-state	53.2	47.3	49.9	6.0	7.8
Collective	9.7	6.4	5.8	4.0	3.1
Private	7.6	9.7	12.2	9.9	11.0
Households	35.9	30.4	31.8	5.1	7.7
FDI	6.7	12.0	13.6	13.7	9.0

*Source:* Elaborated by the authors from Statistical Yearbook of Vietnam 1998 (Table 13) and Statistical Yearbook of Vietnam 2011 (Tables 17, 31, and 162)

**Table 8.6** Number of enterprises/companies by size<sup>a</sup> and ownership in Vietnam, 2010

	Total employed	Number of companies	Average number employed	Very small compa- nies	Small compa- nies	Medium sized companies	Large compa- nies
Total	10,079,886	291,299	36	178,472	105,434	2,562	4,831
Percent	100.0	100.0	–	100.0	100.0	100.0	100.0
State	16.7	1.1	514	0.1	1.7	14.8	21.0
Non-state	61.9	96.4	22	99.2	94.4	67.5	50.1
Collective	2.5	4.1	21	2.9	6.3	2.0	1.1
Private	6.3	16.5	13	19.3	12.7	4.4	1.8
Limited	30.6	56.3	19	59.6	53.0	30.8	20.4
Joint Stock with state	5.0	0.6	295	–	1.1	6.5	8.4
Joint Stock without state	17.5	18.9	32	17.4	21.3	23.8	18.4
FDI	21.4	2.5	297	0.7	3.9	17.7	28.8
100 % foreign	18.9	2.1	317	0.6	3.2	14.7	25.2
Joint Ventures	2.5	0.4	202	0.1	0.7	3.0	3.6

*Source:* Elaborated by the authors from Tables 94, 97, and 112, in Statistical Yearbook of Vietnam 2011 (GSO 2012) Tables 94, 97, and 112

<sup>a</sup>According to the Vietnamese classification: Very small (micro)=less than ten employed; Small=10–200 employed; Medium=200–300 employed; Large=300 or more employed

in 2005 to 61.9 % in 2010 (excluding household agriculture). The contribution by FDI invested companies is more modest with an increase from 19.6 to 21.4 % in the same period.

If, on the other hand, we look at the contributions to GDP we clearly see the importance of FDI. The shares of these companies in GDP (at constant 1994 prices) increased 6.7–13.6 %, while both state and private sector contributions declined (Table 8.5).

An important aspect of the expansion of the private sector is that these companies are primarily small companies (Table 8.6). In 2010 there were in Vietnam

291,299 companies (excluding household agriculture), employing some ten million people. Of these companies, 283,906, or 97.5 % were small or very small companies (employing less than 200 people). The very small companies (employing less than ten people) amounted to no less than 178,472 companies, or 61 % of the total. Of the very small companies, 99.2 % were employed in the non-state sector, while only 0.1 % were employed in the state sector, and 0.7 % in the FDI sector.

A negative feature with the development of the private sector in Vietnam is the bad habit of relying on “connections” (in Vietnamese *quan he*) when doing business. This is often important in Vietnam for rent seeking and in order to get access to land, timber, minerals and other assets, even to get tax reductions, tax holidays, etc. This is nothing but bribery and corruption and has given additional ammunition to party members that have been critical of promoting the expansion of the private sector. Others argue that the public sector is not less corrupt and where the use of *quan he* is as frequent as in the private sector (Communist Party of Vietnam 2005).

## Innovation and Small Firms in Vietnam

An overwhelming number of the new firms in the emerging non-state sector in Vietnam are thus small, and a large part of these are very small (less than 10 employees). Although it is clear that these companies are important for job creation it is not so self evident that these companies also are innovative. Research about innovation and the role of small firms is inconclusive and sometimes contradictory. The Community Innovation Surveys (CIS) of the EU show that while small firms as a rule spend no or little money on R&D, they can indeed be innovative, although these *incremental innovations* might be difficult to capture and measure (see e.g. Gault 2010).

There are reports that claim that the role of small innovative firms is highly exaggerated (see e.g. Lowrey 2011) while there are also reports stressing the advantage that small firms could have with dynamic entrepreneurs (see e.g. Hogg 2011). In the case of Vietnam this area has only recently come to the attention of researchers but there are quite a few studies that show some success stories with innovation in small firms in Vietnam. These are often connected with village-based small manufacturing firms that organize themselves in *clusters* (see e.g. Voeten 2012 and Viet Le and Harvie 2010). But many small firms in Vietnam are also successful in the export sector, usually collaborating in clusters (see e.g. Ngoc Anh Nguyen et al. 2007).

## The Controversy Over Equitization

Reforming the enterprise sector in Vietnam has not only consisted of opening up for a non-state, or private, sector. An important task has also been to reform the SOEs, many of which have proven to be grossly inefficient. One way has been so-called

equitization which has been, and still is, very controversial in Vietnam, both with respect to forms of equitization and results. Or in the words of an observer:

“Equitization (privatization) has been at the core of the policy debate in Vietnam over the last decade but the government’s attitude seems ambivalent. On the one hand, equitization is emphasized in policy statements. On the other, the progress on equitization has been relatively modest and SOEs continue to dominate the Vietnamese economy.” (Sjöholm 2006)

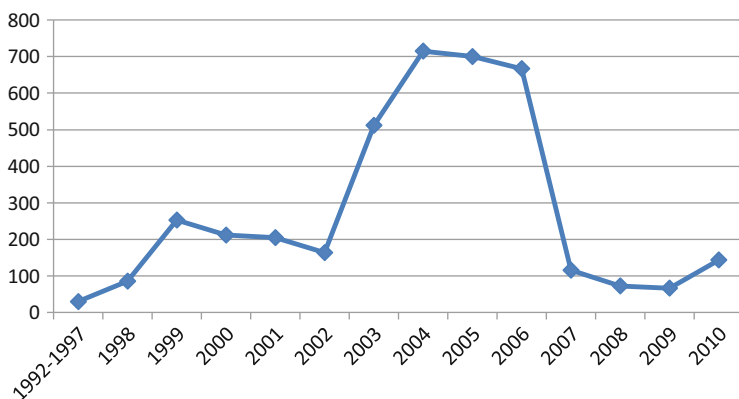
When it comes to state vs. non-state, or private, sector Communist Party leaders on the one hand argue that the “private enterprises shall be an engine of growth and development in Vietnam” but in they also make it clear that “SOEs shall continue to play a leading role in the economy” (CPV 2000 and reconfirmed in a Resolution of the 11th Party Congress in 2011).

There was a consensus in the Communist Party that SOEs had to be reformed because most of them were working with obsolete machinery and equipment. Surveys showed that up to one-third of the physical assets (plant, machinery and equipment) were useless (Le Dang Doanh 1996). In an attempt to cut down on subsidizing loss making SOEs the Government SOEs with poor profitability to borrow money from other SOEs, banks and other financial sources, creating “a complex mass of cross-subsidization and indebtedness (and) at the end of 1995, the aggregate debt of the SOE sector was reported to exceed the sector’s aggregate turnover in the same year” (Sjöholm 2006).

The Government started a pilot equitization program in 1992 that was extended in 1996 with a formal Decree on equitization. In 2002 a stock market was opened that would also contribute “to support the process of equitization of state enterprises and the development of non-state enterprises” (Nguyen Duc Thanh 2011). The decree of 1996 had targeted so-called non-strategic SOEs that were allowed to become joint-stock companies. The equitization process was very slow and at the beginning restricted to limited number of non-profitable SOEs (until 1998 only 18 SOEs had been equitized). One reason was that there was a lot of resistance to equitization from many vested interests, above all SOE managers. Many managers saw changing ownership structure as a threat since they would be faced with tougher demands (no longer any “soft budget constraints”) and other changes.

The main objective of the SOE reform in Vietnam was at the outset to consolidate the role of the SOEs in the economy, by making them more competitive, rather than privatizing them. As a means to reach this objective the Government set in 1994 up 18 General Corporations (GC) and 64 Special Corporations (SC), acting as large conglomerates with SOEs belong to what was considered strategic industries, or specific geographical areas. Later on, with the State Owned Enterprises Law of 2003, the Government also decided launch a pilot project, establishing five so-called Economic Groups (EC): Post & Telecommunications, Textiles, Ship Building, Coal and Minerals, and the Bao Viet Financial Group (Sjöholm 2006). They were directly reporting to the Prime Minister, while the Chairman of the Board and the CEO were appointed by the Prime Minister.

Until 2011, 3,800 small and medium-sized SOEs had been equitized, corresponding to 17 % of total SOE assets. The remaining 1,824 SOEs are larger



**Fig. 8.3** Vietnam: number of equityizations, 1992–2010. *Source:* Le Dang Doanh (2011)

companies, such as commercial banks, or they are organized in State-Owned Corporations, or Economic Groups, and are very difficult to be equityized (Vo Van Kiet 2007). The equityization process has been slowing down significantly from 725 SOEs in 2005 to 73 in 2008, 105 in 2009 (Fig. 8.3).

## The Imperative to Downsize the State Sector: Perhaps the Most Important Reason for Reforms in Cuba

Like in Vietnam there was after the Revolution a campaign to collectivize large parts of the economy. In March 1968 the Cuban Government, facing increasing pressures against resources, nationalized over 55,636 companies—mainly small establishments—of which 17,000 food retailers and 11,299 bars, restaurants and other food vendors (Ritter 1974: Table 6:1). As a consequence, with this “Revolutionary Offensive” the only private sector left was a small sector in agriculture and to some extent self employment primarily in transport.

That the “Revolutionary Offensive” was a serious mistake—both tactically and strategically—has been recognized by the leaders of the party and the government—although reportedly not by Fidel Castro (see Brundenius 1984, p. 55). However, addressing the National Assembly in December 2010, Raúl Castro recognized that “we were absolutists about this principle and moved almost all economic activity into the hands of the state. The steps we have been taking and will take in the expansion and liberalization of entrepreneurship are the fruit of deep consideration and analysis and we can be sure that this time there will be no turning back” (quoted in Peters 2012).

The Government has since 1968 from time to time made “tactical retreats” with respect to *cuenta propia* (self-employment). In 1975 *trabajo por cuenta propia* (TCP) was accepted as legal activity in specially dedicated areas, such a

**Table 8.7** Employment by ownership in Cuba (%)

	1997	2007	2010	2011
State	84.9	82.9	83.8	77.3
Non-state	15.1	17.1	16.2	22.7
Cooperative	9.0	5.0	4.4	4.2
Private	6.1	12.1	11.8	10.7
<i>of which: self-employed</i>	3.4	2.8	3.0	7.8

Source: ONE (1998, 2008, 2012)

**Table 8.8** Employment by ownership in Cuba with forecast for 2015

	2010		2012 (est)		2015 (forecast)	
	000	%	000	%	000	%
State	4,178.1	83.8	3,700	74	3,000	60
Non-state	806.4	16.2	1,300	26	2,000	40
Cooperatives	217.0	4.4	250	5	500	10
Private	589.4	11.8	1,050	21	1,500	30
<i>of which: self-employed</i>	147.4	3.0	450	9	900	18
Total	4,984.5	100.0	5,000	100	5,000	100

Source: ONE (2012); estimates and forecasts by the authors

taxidrivers, hairdressers, gardeners. but also professional occupations such as dentists, doctors, architects, and engineers, *provided that they had graduated before 1964*. However, as late as in the 1981 the number of self employed was only about 46,500 persons. Private agricultural markets were again being allowed in the 1980, but after the so-called rectification campaign at the end of the 1980s the number of *cuentapropistas* declined to 25,200 (Díaz et al. 2012).

But after the economic crisis hardly hit Cuba after the demise of the Soviet Union, and with rising unemployment and underemployment, the Government again saw *cuentapropismo* as a tactical retreat, as a survival measure, during the “special period in period of peace” as it was officially called. In 1995 a list of 117 occupations was published in a Decree, later expanded to 136 occupations, although only in services and transport, thus no possibilities for professions requiring higher qualifications. This Decree led to increasing self-employment which totaled 138,100 in 1995 (ONE 1998).

However, self-employment increased only slightly in the following years and by 2010 it had only increased to 147,400 persons, or 3 % of total employment (see Tables 8.7 and 8.8). In September that year the Government informed the Cubans that the Government saw it necessary to initiate massive dismissals of workers and employees from the public sector.

At the outset the Cuban government had plans to reallocate 500,000 workers and employees from the public to the non-state sector—without any plan, just assuming that they would join the number of self-employed—a tentative deadline was set to the end of March 2011. Within a couple of years it was envisaged that in addition at least 800,000 workers and employees would have to leave the state sector and be *disponibles* for a not very well-defined non-state sector.

Practically all that have left the public sector have received licenses to work as *cuentapropistas*. In November 2012 the Cuban Statistical Office (ONE) reported that the number of self-employed had reached 391,500 by end of 2011 (see ONE 2011: Table 7.2), up from 147,000 in 2010 by the time of *Lineamientos*. The Government has a goal of a non-state sector employment of 40 % by 2015. This could very well be reached but it is problematic if it will mainly be the result of increase in self-employment (see Table 8.8).

It is clear that the government prefers to prioritize the creation of cooperatives. A challenge is to create *independent* cooperatives that are not just disguised state owned companies, like the UBPCs in the sugar sector (cf. Chap. 5 in this volume). It is interesting to note that in the first Web edition of the *Anuario Estadístico 2011*, the employment in the cooperative sector showed an unbelievable increase over 2010 with a corresponding decline of the private sector (excluding the TPC). However, in later editions of the same *Anuario* the numbers are reversed (increase of private sector and small decrease of cooperative sector) indicating that there had at the outset been a reclassification of “cooperative” by including farmers that are part of ANAP (the small farmer association), apparently an error that was later rectified. On the other hand, there seems to be a serious attempt by the government to foment cooperatives by encouraging for instance taxi drivers, barbershop and beauty parlor employees in former state owned and locally owned companies to organize themselves in so-called *urban cooperatives* (Decreto Ley 305/2012 sobre Cooperativas No Agropecuarios). From 1 July 2013 a range of new urban cooperatives started operating on an “experimental basis”, in areas such as transport, construction, agricultural markets and collection and recycling of garbage. These cooperatives would operate in areas that “had been inefficiently managed by state companies in the past”, according to a government official (Havana Times, 2 July 2013).

## Problems with *Cuentapropismo*

One problem with *cuentapropismo* (self-employment) as a solution to the overly staffed state sector is that in the past self-employment has just been used, or tolerated, by the Government as a safety valve in economic downturns. This was the case, for instance, when the Government in 1993 opened up for an increased, but controlled, number of *cuentapropistas* by increasing the number of approved activities from 41 to 158. The intention was “to create space for new economic activity where the state was not operating: when private operators were in direct competition with state enterprises, licenses were revoked” (Morris 2011, p. 132).

In the current reform process it seems that this time it is serious, not just a tactical retreat. But then we have another problem. Are the approved activities all adequate and sufficient to absorb the redundant manpower in the state sector? Let us look at the numbers, what the plan is, and what problems might be expected.

From September 2010 (when the announcement was made) until mid-2012, about 233,000 Cubans had been incorporated as *cuentapropistas*, a quite

dramatic increase. But it appears that while the idea of increasing opportunities for self-employment—at least at the outset—was primarily targeted at creating jobs for an overly staffed state sector, a large part of the new self-employment are people who have not before—statistically—been included in the labor force, according to the Deputy Minister Labor and Social Security, Jose Barreiro (Havana Times, 14 August 2012). He said that “though they lack reliable statistics, the fact is that only 31 % of the self-employed come from government businesses or institutions.”

Many of the people joining the TPC sector are pensioners, retired people and also people who have been in the black market and other people that have been outside the labor force. According to a survey taken in September 2011 only 17 % of the workers having been granted licenses were actually coming from the state sector, while 67 % had no labor market link, and 16 % were pensioners (Díaz et al. 2012).

It is not clear if “self-employment by university graduates” will continue to be prohibited. So far (as of July 2013) it is not possible, for instance, for an entrepreneurial graduate student to start up a software company for the simple reason that computer engineers are not listed among the 181 professions that can be granted licenses.

Over 140,000 state employees left the state sector in 2011 and it is estimated that an additional 110,000 state employees left the sector in 2012 thus being *disponibles* for incorporation in the non-state sector. This means that 50 % of the first downsizing phase of the state sector would be finished. By the end of 2012 the self-employment sector is estimated to comprise over 400,000 people with official licenses. They work in the 181 types of occupational fields as authorized by the authorities. Most of them are employed in the gastronomic and transport sector (Infolatam 20 August 2012). Until April 2012 over 250,000 self-employed people had been incorporated in the trade union movement according to official figures (Havana Times, 23 August 2012).

Until now (April 2013) *cuentapropismo* is thus limited to 181 activities, practically all in various services and transport. Many such services are important but not many—if any—are linked to productive value chains. Most do not require highly qualified labor, which is perhaps Cuba’s prime asset. In addition to the 181 activities the list should be expanded to include possibilities to start *innovative* firms that can make full use of the highly qualified labor that is now available.

Because of low pay there is a risk that highly qualified labor will leave their jobs to find low quality—higher paid—jobs in the non-state sector. It is reported that 14,000 teachers left the classroom in 2011 with medical leave certificates, or requesting self-employment licenses, while during summer 2012 another 4,000 gave up teaching. “Meanwhile, 80 % of the slots to study teaching careers are vacant” (Havana Times, 25 October 2012).

One possibility is that dismissed workers increasingly organize themselves in cooperatives that is a less controversial property form than setting up private business (see e.g. Piñeiro 2011).

## The Dilemma of a Stagnating and in the Long Run Declining Population

Cuba is a bit ironically a “victim of its own success” in the sense that its success in raising life expectancy coupled declining fertility rates has led to not only an ageing population (that is a trend in many developed countries) but it has led to stagnating population, and in the longer run also a diminishing population, according to official forecasts. This is sharp contrast with Vietnam (see Table 8.9 below).

By 2020 more Cubans will be leaving the labor force than entering it. Low fertility rates are also part of the problem. The Cuban Statistical Office (ONE) says that about 2 million of the island’s 11 million inhabitants, or 17 %, are over 60 years old (compared to 9 % in Latin America). Emigration of some 35,000 people per year is adding to the problem.

The Cuban Vice President Marino Murillo, sometimes referred to as the “architect” behind the reforms, seems to be pessimistic, saying that “we must be perfectly clear that the aging of the population no longer has a solution” (Associated Press, 7 August 2012, quoted in ASJE 23 August). But Murillo also said that the government is looking at measures that could stimulate fertility rates. Another likely measure is to extend the retirement age gradually for women from 55 as it is today to 60 years, and from 60 to 65 years for men. The government is also encouraging retired people to continue working while still keeping their pensions. This might be difficult as long as salaries are so low.

Can the negative migration flows be reversed? China and Vietnam are recent examples that such a reversal is possible. This might happen if economic reforms become a success like in China and Vietnam. A revitalized Cuban economy might even attract immigrants for other parts of Latin America. From “Brain Drain to Brain Gain” is an interesting research project at the Development and Policies Research Center in Vietnam. It clearly shows that the *Viet Kieu* (overseas Vietnamese) have made important contributions to the rapid development of Vietnam after “Doi Moi,” through remittances as well as investment projects (Pham 2011).

**Table 8.9** Population trends in Cuba and Vietnam, 2010–2030

	2010	2020	2030
<i>Cuba</i>			
Population (million)	11.3	11.2	11.0
0–14 years (%)	17.3	13.5	12.7
15–64 years (%)	70.3	70.3	64.5
65+ years (%)	12.4	16.2	22.8
<i>Vietnam</i>			
Population (million)	87.8	96.4	102.0
0–14 (%)	23.6	21.9	17.6
15–64 (%)	70.4	70.8	69.6
65+ (%)	6.0	7.3	12.8

Source: United Nations (2010)



## From Extensive to Intensive Growth in Cuba: The Role of Entrepreneurship and Innovation

The Cuban economic model has been based on so-called *extensive growth*, meaning that the economic growth has primarily been determined by the more or less proportional expansion of factor inputs, that is capital and labor. This *extensive growth model* was also characteristic of the Soviet Union during the heydays of central planning (Kornai 1992). In such a model the economy expands at the same rate as capital investments and the expansion of the labor force. When these factors of production decline, economic growth slows down, and Cuba is a case in point. The problem with such growth models is that they tend to neglect the role of science and innovation and how these are applied to production.

Countries with scarce capital and labor must move towards an *intensive growth model* where innovation takes the lead in increasing productivity. This comprises not only labor productivity as such but above all productivity linked to innovation—so-called Total Factor Productivity (TFP), or sometimes referred to as the “residual factor” (Coombs et al. 1987). In the period 1962–1999 Cuban GDP increased at an annual rate of 2.4 %, while at the same time gross investments expanded at a rate of 2.8 %, and the labor force at a rate of 2.0 % (Brundenius 2002). In the same period, labor productivity increased by a mere 0.4 % annually. There have so far been very few studies that highlight the contribution of TFP to economic growth in Cuba. However, one by Manuel Madrid-Aris (1998) and another more recent one by Yaima Doimeadiós (2011) both clearly point at the low contribution of TFP, especially after 1980, indicating an inefficient use of Cuba’s increasingly skilled labor.

Cuba is confronted with two major long-term problems: low investment rates and a stagnating, soon shrinking, labor force. This means that Cuba must develop a *new intensive growth model* based on increasing application of science, technology and innovation (STI) in production. It is clear that state monopoly with central planning is not conducive to an intensive growth model. There is no scientific evidence that state ownership per se is better or worse than private ownership in providing a innovative environment but it is the monopoly situation coupled with state bureaucracy that is the problem (Stiglitz 1994). It is not property rights that are at stake. What is at stake is the *competition* on a market with clear rules of the game for *all* companies, irrespective of ownership. This is a challenge for the Cuban reformers and where the Vietnamese experience can be instructive.

Cuba has a highly qualified labor force that can be very innovative, given the right incentives and opportunities. This is where the new entrepreneur comes in. Cuba is a rather unique situation. It finds itself in a deep and serious economic crisis but—in contrast to many other developing countries—it is endowed with human capital that could be an important means to redress the situation. But this requires a new open minded strategy of how to make full and efficient use of this capital.

## The Recognition of a Dynamic SME Sector in the Vietnamese Development Strategy

It is now possible for talented young Vietnamese, who have just graduated from universities, or returned back to Vietnam after studies abroad, to start up their own companies. This has been the result of a growing awareness that the government had to move from a passive role to a more pro-active role in actually promoting, and actively supporting, the development of an SME sector, irrespective of being state or privately owned business. Since most of the small and medium companies tend to be private, the support to SMEs by definition primarily refers to the private sector.

In 2001 the Government published a Decree, whereby it recognized that “(d)velopment of SMEs is an important task in the Socio-Economic Development Strategy, (and) accelerates the industrialization and modernization of the country” (Government of Vietnam 2001). Furthermore, “(t)he State shall *encourage and facilitate* SMEs release their initiatives and creativity, improve their managerial capacities and develop their science, technology and human resources,” and that “(t)he Government shall support the investment (of SMEs) through *financial and credit measure*,” In support of this Decree a Credit Guarantee Fund was set up in order “to guarantee credits to SMEs that do not have sufficient collateral, mortgage to get loans from credit institutions.”

In a new Decree in 2009 the Vietnamese Government went further by setting up a *Council for Encouragement of Development of SMEs*, directly under the Prime Minister (Government of Vietnam 2009). It also set up a *Center for the Promotion of SMEs* to materialize assistance policies and programs, an institution that very much resembles SEBRAE (Brazilian Support to Micro and Small Firms).

## Concluding Remarks

It is clear that Cuba can learn quite a deal the Vietnamese reform process with respect to the creation of a dynamic non-state sector based innovation and entrepreneurship. But a non state sector cannot be based on self-employment alone. In both China and Vietnam this has been the case on their transitions from planned to market economy. In Vietnam 61.9 % of the urban labor force was in 2010 employed in the non state sector. Out of these, 85.8 % were working in the private sector, 10.2 % as self-employed, and only 4.0 % in cooperatives (GSO 2011: Table 97). In China 66.9 % of the urban population was in 2011 employed in the non-state sector, with 64.9 % of these working in the private sector, while 29.7 % as self-employed, and only 4.3 % in the cooperative sector (NBSC 2012: Table 4.1). In comparison, in Cuba the non-state sector employed 30.5 % in 2011, of which 42.6 % were employed in cooperatives (primarily former state owned farms), 31.8 % in private companies (mainly farmers) and 25.5 % were working as self-employed (ONE 2012: Table 7.2).

There are many reasons why the downsizing of the state sector is a good idea. An important purpose is employment creation. The state sector is not very good at

running small businesses that create employment opportunities, as demonstrated in the Vietnamese and Chinese cases. SOEs in Cuba and Vietnam are as a rule medium, or large enterprises, although often inefficient with low labor productivity, with a large number of workers. To this extent the expansion of self-employment, *cuentapropismo*, as a means of enhancing the start up of micro and small companies, can be a good solution.

However, even if the immediate problem is to find employment and income opportunities for hundreds of thousands of Cubans looking for work, this is not a medium-term solution, even less so a long term solution. The reason is demographic: low fertility rates, declining labor force, ageing population.

There must be the same rules for all types of ownership. The Vietnamese experience of “leveling the playing field” could be worth looking into. The Government must set up support mechanisms that are conducive to productivity growth of the small scale sector. This means that the sector must be supported by a new range of institutions, such credits, wholesale sector, a legal framework that allows small business to thrive and expand, as the Vietnamese and Chinese experiences give ample evidence of. A good sign is that during spring 2013 there have indeed been a series of new decrees in this direction which are expected to give positive results.

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# Chapter 9

## Science, Technology, and Innovation Policies and the Innovation System in Cuba: Assessment and Prospects

Jorge Núñez Jover and Luis F. Montalvo Arriete

### Introduction

This chapter provides an overview of Cuban science, technology, and innovation policy (“STIP”).<sup>1</sup> The Economic and Social Guidelines (PCC 2011a, b), defining Cuba’s current principal transformations, propose significant changes in STIP. The final 313 Guidelines were approved on April 8, 2011 following a broad public discussion of the project. Groups of experts and representatives of ministries and social organizations are currently developing recommendations for policies and strategies for mobilizing the productive potential of the country.

A special feature of the development of a new STIP in Cuba is that diagnostics are taking place at the same time as the development of proposals to inform decision-making. In order to contribute to the assessment process, we examine the defined STIP objectives and evaluate their outcomes through two methods. The first method relies on an analysis of indicators for inputs and outputs published by the RICYT<sup>2</sup> based on information from Cuba. Secondly, we reviewed documents from the Ministry of Science, Technology, and Environment (CITMA). Subsequently, we comment on some of the proposals in Chapter V of the Guidelines, “Science, Technology, Innovation and Environmental Policy,” which reflect the country’s proposed new policy. Our evaluation confirms that creating a new policy is necessary. Finally, we formulate some observations about the emerging STIP.

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<sup>1</sup>This is a summary of the authors’ research in the Department of Social Studies in Science and Technology, 2010–2012.

<sup>2</sup>*Red Iberoamericana de Indicadores de Ciencia y Tecnología* (Ibero-American Network of Indicators for Science and Technology).

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## The STIP's Response to Directives and Objectives, 1995–2010

Existing STIP policy has its origins in the 1990s. With the creation of the Ministry of Science, Technology, and Environment (CITMA), a set of policies were formulated that emphasized innovation and the role of research institutions in the country's economic recovery.<sup>3</sup> Gradual implementation of the new System for Science and Technological Innovation (SCIT) began in 1996. Its principal purpose was to promote the production of efficient and competitive goods and services that would contribute to a modern economy advantageously inserted in the international market.

CITMA (1995):4. Some areas, such as the biotechnology industry, have seen progress, but as discussed below, this success has not been observed in other sectors and institutions.

The research has identified two central issues around implementation of Cuban science and technology policy<sup>4</sup>: *developing the country's scientific and technological potential*, and *better harnessing that potential to increase the impact of science and technology in the economy and society*. The STIP agenda was shaped by these two problems, prompting the design and implementation of explicit and implicit policies that were refined in application.

As mentioned above, our analysis is based on diachronic Science and Technology indicators developed by RICYT and a review of documents from CITMA that provide information on difficulties detected in the system's operations. We turn first to some input and output indicators for the Science and Technological Innovation System.

### Input Indicators

#### *Financial Resources*

Figure 9.1 shows the amount of Science and Technology Activity (STA) and Research and Development (R&D) as a percentage of Gross Domestic Product (GDP).<sup>5</sup> Note that beginning in 1995, despite the country's financial difficulties, R&D expenditure as a percentage of GDP maintained average growth of 0.52 %. However, total expenditures in STA tended to decline slightly, and still have not reached the desired amount of 1 %.

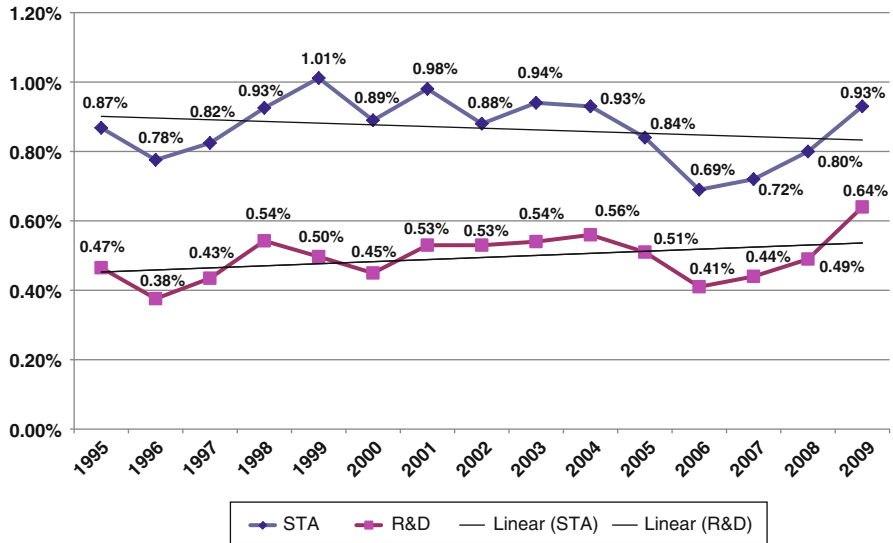
Figure 9.2 also shows the country's investment in STA and R&D, identifying the source of financing and relative participation of government, business<sup>6</sup> and foreign

<sup>3</sup>For additional information see, CITMA, "El Sistema de Ciencia e Innovación Tecnológica." Havana, December 1995, pp 3–61; and CITMA (1997): "Sin la ciencia y la técnica es imposible concebir la recuperación económica". Carlos Lage Dávila. (Report from the annual meeting.) Reunión de Balance Anual del Ministerio de Ciencia, Tecnología y Medio Ambiente.1997, 15p.

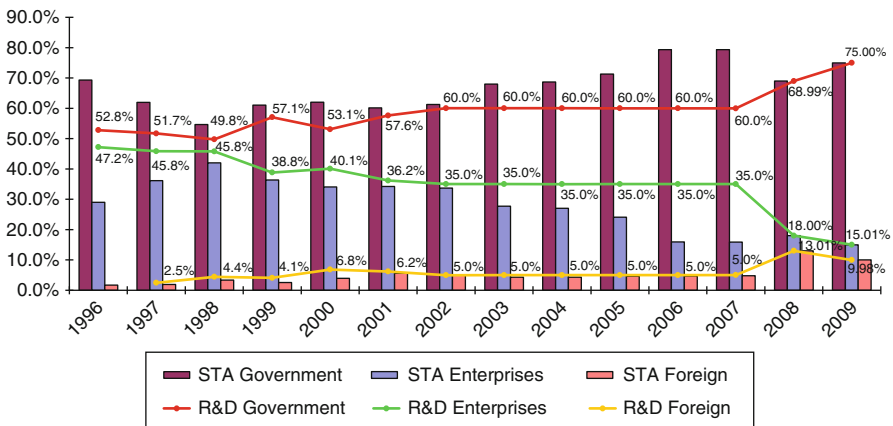
<sup>4</sup>Policy implementation is understood as the phase in which public policy takes the form of concrete actions through legal provisions, organizational structures and operational mechanisms.

<sup>5</sup>The total value of goods and services produced in the country in a year.

<sup>6</sup>In Cuba, private enterprise is limited, and except in areas with foreign capital investment, private entities do not engage in STA, so that reference to business financing refers in most cases to State-owned enterprises.



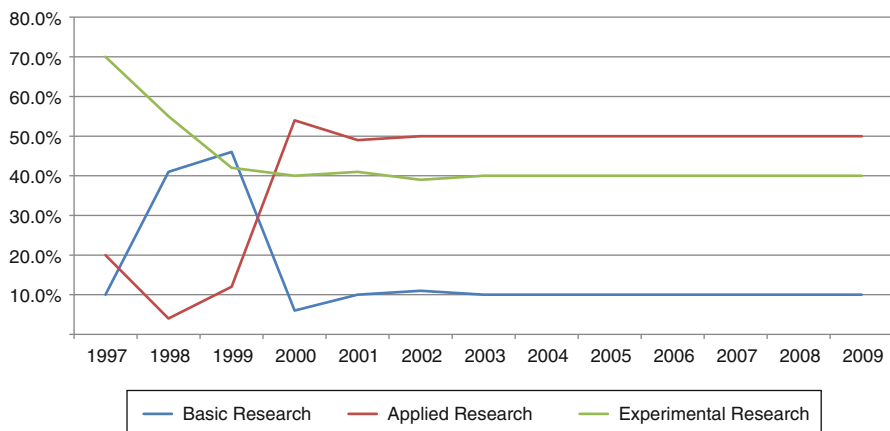
**Fig. 9.1** Total Expenditures in Science and Technology Activities and R&D as a percentage of GDP, 1995–2009. *Source:* Data from RICYT 2011. Note on GDP: The measurement used in the historical series for Gross Domestic Product (GDP) beginning in 2000 includes a revalorization of social services with prices that incorporate elements of profitability and reflect the value added of these activities, given that the Cuban economy and its social system, health, education, cultural, and sports services, among others, have a socioeconomic impact much greater than that registered by expenditures, which is the traditional method for calculating these activities



**Fig. 9.2** Expenditures on Science and Technology by source of financing (%) 1996–2009. *Source:* Data from RICYT 2011

investment. For R&D financing, support from the government showed a positive trend after maintaining levels of 60 % during five years, and reaching 75 % participation in 2009. Financing levels from foreign investment and other sources also increased slightly, although they remained stable at 5 % from 2002 to 2007. In 2009,





**Fig. 9.3** Expenditures by type of research (%) 1997–2009. *Source:* Data from RICYT 2011

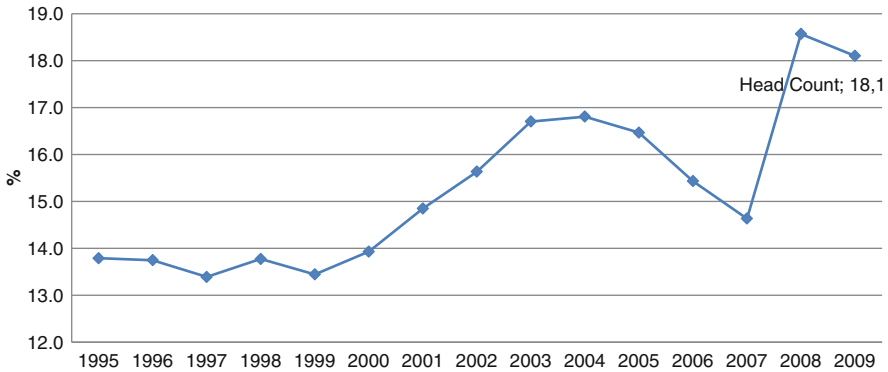
this amount increased, reaching 10 %. At the same time funding provided by businesses decreased significantly between 2007 and 2009, from 35 to 10 %.

The pattern for STA investment is quite similar, although relative funding levels vary. Generally, the State is almost the exclusive financier of STA in Cuba, contributing an average of 95 % of financing.

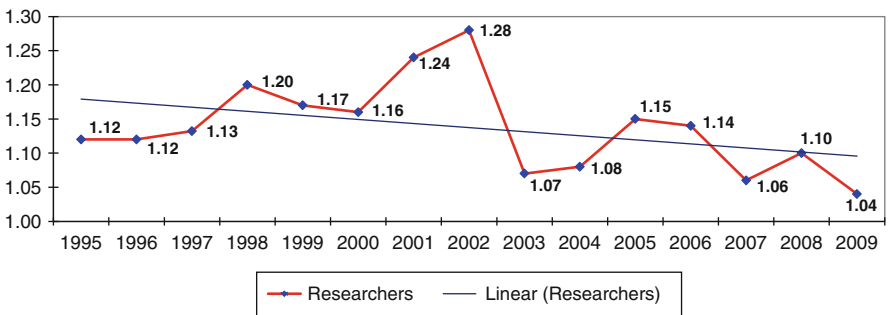
Figure 9.3 presents expenditures by percentage in types of research between 1995 and 2009. Notably, between 2001 and 2009, amounts remained constant, with a null slope of 10 % in basic research, 40 % in applied research and 50 % in experimental research. For example, RICYT data from 2010 indicates that in 2008, Cuba's percentage investment dedicated to applied and experimental research combined (89.98 %) was greater than that in the United States (82.61 %), Portugal (80.28 %), Spain (79.11 %) and Argentina (71.95 %). However, of those countries, Cuba had the least amount of its resources in basic research, at 10.02 %, compared to Argentina (28.05 %), Spain (20.89 %), Portugal (19.72 %) and the United States (17.39 %).

## ***Human Resources***

Figures 9.4, 9.5, 9.6 and 9.7 depict human resources in science and technology. Figure 9.4 indicates the number of workers employed in STA for every 1,000 individuals in the economically active population (EAP). Between 1995 and 2009 this number trended up, from 13.8 to 18.1. The indicator for employment in STA was similar, reflecting the number of individuals working full- or part-time for SCIT. In 1995, there were 62,738, whereas by 2009 this had increased to 94,017.



**Fig. 9.4** Science and Technology Personnel per 1,000 members of the Economically Active Population (EAP), 1995–2009. *Source:* Based on data from (RICYT 2011)

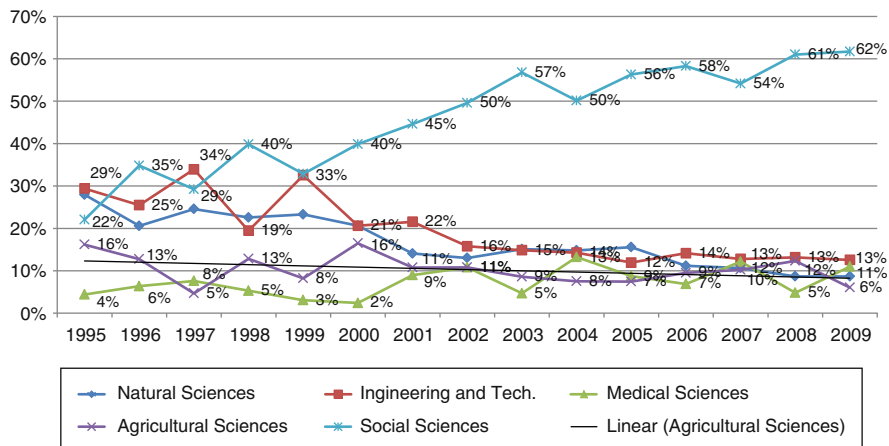


**Fig. 9.5** Number of researchers for every 1,000 EAP, 1995–2009. Note: Researchers include R&D scholarship recipients. *Source:* Based on data from (RICYT 2011)

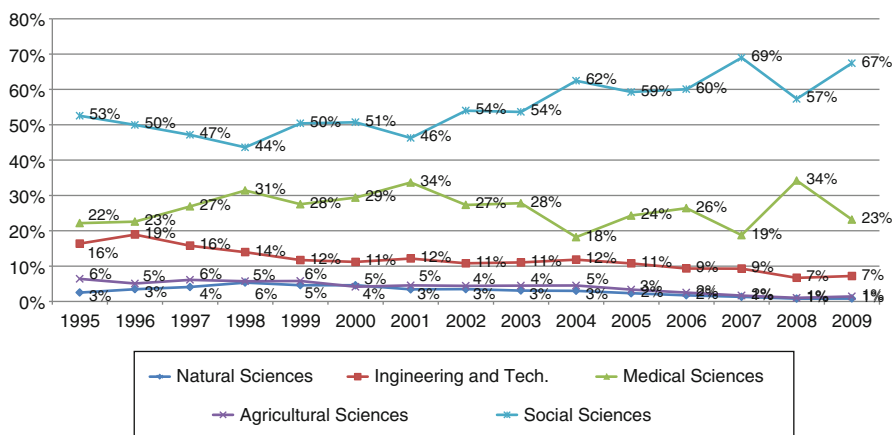
Figure 9.5 shows the relative weight of researchers in the workforce.<sup>7</sup> In 2008, the country had 5,525 researchers, the equivalent of 1.11 researchers for every 1,000 individuals in the economically active population (EAP). Although the following year this indicator fell to 1.04, and a declining trend is discernible, this number is still above many countries in the region, with the notable exceptions of Argentina (4.1) and Brazil (2.11) (RICYT 2011).

The number of doctorates awarded in the sciences (Fig. 9.6) between 1995 and 2009 were heavily skewed toward the social sciences. Social science was the most represented field, making up 25 % of all the science doctorates in 2009, with sustained growth through 2009, reaching 62 %. At the same time, there was a noticeable decrease in training doctors in Engineering and Technology. Between 1995 and 2009 they decreased by around 20 %. Finally, university graduates in these same areas follow similar trends (Fig. 9.7).

<sup>7</sup>The job classification of “researcher” in Cuba is limited to only those researchers who are categorized as such, and does not include other professionals who may also conduct research, such as university professors who engage in research activities as part of their jobs, but who are classified as professors, since teaching is their primary activity. See (CITMA 2010).



**Fig. 9.6** Doctorates by Areas in the Sciences (%), 1995–2009. *Source:* Based on data from (RICYT 2011)

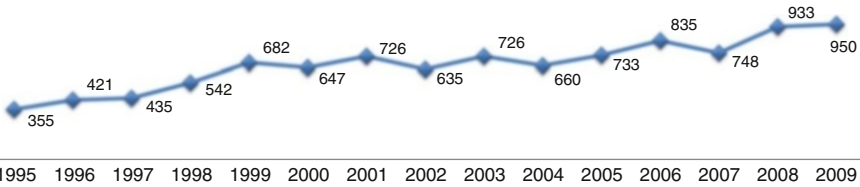


**Fig. 9.7** Graduates by Science Areas (%), 1995–2009. *Source:* Based on data from (RICYT 2011)

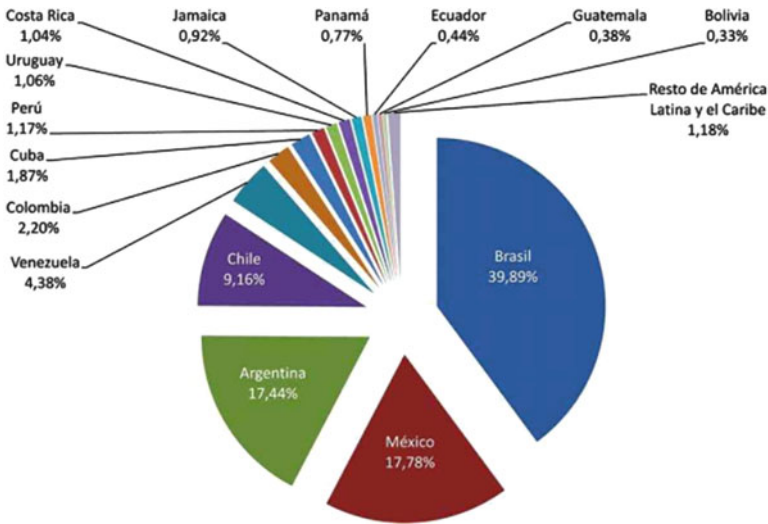
## Output Indicators

According to the Santiago Manual (2007) some of the output indicators for research and technological development include publications, patents filings, and the exports of goods and services with high technology components.

Levels of Cuban scientific articles included in the Science Citation Index (SCI) are shown in Fig. 9.8. Cuban scientific publications have increased slightly over time, despite minor fluctuations in particular years. Figure 9.9 indicates Cuba’s position within the Latin America and Caribbean region with respect to productivity



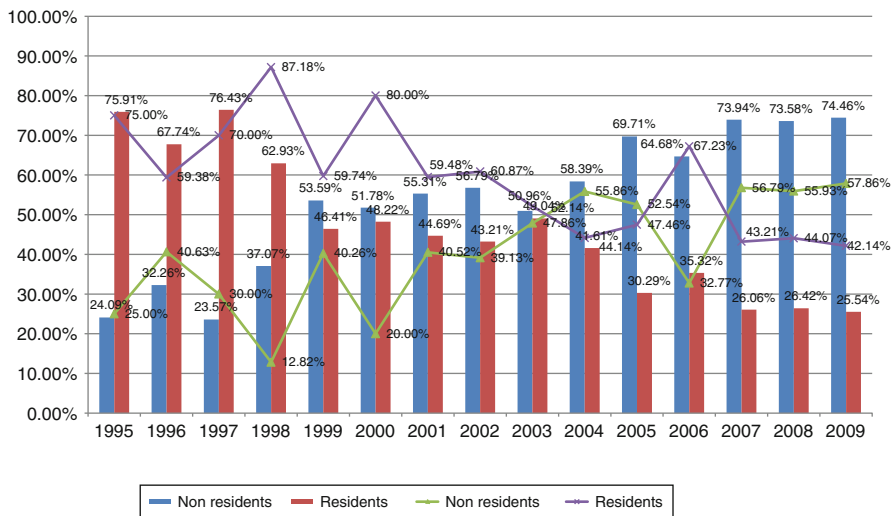
**Fig. 9.8** Publications from Cuba in the Science Citation Index (SCI) 1995–2009. *Source:* Based on data from (RICYT 2011)



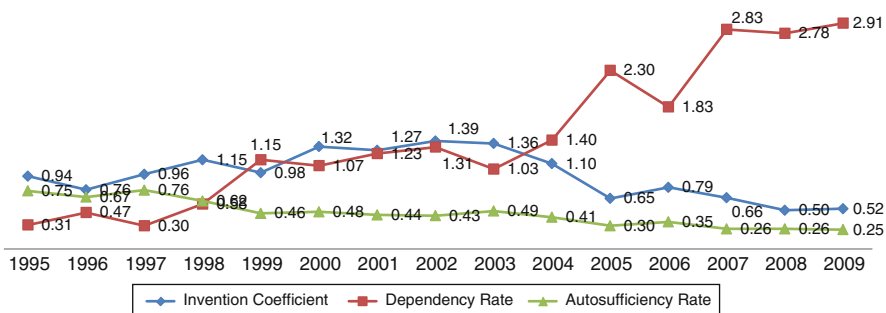
**Fig. 9.9** Distribution by percentage of all scientific publications 1973–2008 in the Science Citation Index (SCI), Social Science Citation Index (SSCI) and in the Arts and Humanities Citation Index (A&HC). *Source:* Lemarchand (2010)

in generating new knowledge registered in international bibliographic databases. For example, Brazil leads significantly with the highest number of citations in the databases, whereas Cuba occupies seventh place, with 1.87 %, indicating progress in the capacity for international dissemination of the country’s scientific production. Notably, from 1973 to 2008, only four countries (Brazil, Mexico, Argentina and Chile) produced 85 % of all the major scientific publications.

Figure 9.10 shows the relative number of patent applications granted to Cuban nationals and to foreigners, based on total applications and patents awarded. Cubans patented very little, and there is a negative trend beginning in 2000. Although this may be due to multiple factors, ranging from financial difficulties to protection of inventions via secrets, the fact is that domestically generated inventions are declining. This is further demonstrated in Fig. 9.11, based on the values for invention coefficients and the rates of dependency and self-sufficiency.



**Fig. 9.10** Percentage of applications and awards of patents to residents and nonresidents, 1995–2009. *Source:* Based on data from (RICYT 2011)



**Fig. 9.11** Invention coefficient and rates of dependency and self-sufficiency, 1995–2009. *Source:* Based on data from (RICYT 2011)

Beginning in 2004, the invention coefficient<sup>8</sup> has values below 1.0, while the dependency rate<sup>9</sup> tends to increase beginning in 2005. A concomitant decrease is observable in the self-sufficiency rate, which provides a general expression of the degree to which a country relies on inventions developed domestically.

<sup>8</sup>The number of domestic patent applications per 1,000 inhabitants and the proportion of the population that has developed inventions and applied for registration in the patent office.

<sup>9</sup>The number of foreign patent applications compared to domestic ones, and the degree to which the country depends on inventions developed outside its borders.

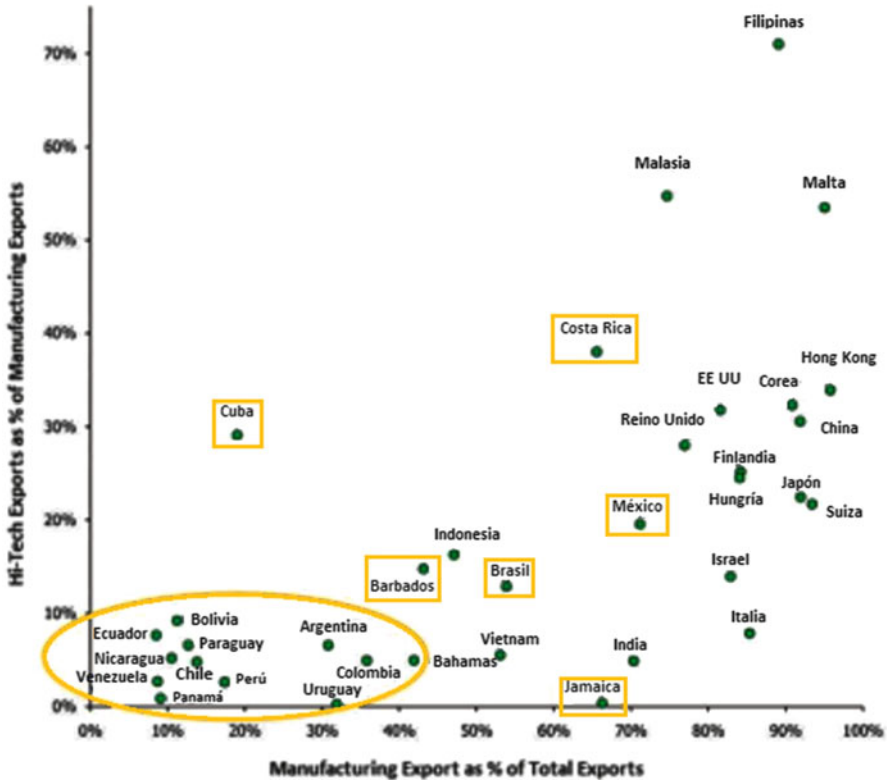


Fig. 9.12 Level of technological components in exports by country in 2005. Source: Lemarchand (2010)

In knowledge-based economies, science, technology, and innovation contribute to productivity. Based on 2005 data, most Latin American countries have relatively low levels of technological content in manufactured exports (Fig. 9.12). However the cases of Costa Rica and Cuba are significantly above the regional average. The Costa Rican case is due to the establishment of large multinational businesses in the information technology sector, such as IBM, INTEL and HP. In the Cuban case, this is primarily due to increased biotechnology products and services resulting from prioritization of the sector’s development and the combined effect of two fundamental factors: the need to provide domestic health services, and the need to increase exports to obtain foreign exchange, which in turn contributes to refinancing the development of the sector.

As these indicators make clear, these are some STIP outputs that will require attention in the next phase.

## STIP Problems Identified in CITMA Documentation

Another method for evaluating the STIP and its impact on the System for Science and Technological Innovation (SCIT) is through analysis of documents with baseline data issued by the national science and technology body and some of its agencies. We identified the frequency that problems with the System appear in five representative documents from different periods. These documents are:

*Document 1.* Ministry of Science, Technology, and Environment (CITMA). “La ciencia y la innovación tecnológica en Cuba. Bases para su proyección estratégica.” (“Science and Technological Innovation in Cuba. Bases for Strategic Planning.”) May 1998, p. 39–43.

*Document 2.* Ministry of Science, Technology, and Environment (CITMA). “Bases para el perfeccionamiento y desarrollo de la innovación.” (“Bases for Improving and Developing Innovation.”) 2003.

*Document 3.* Cuban Observatory for Science and Technology (OCCyT). Expert panel report. “Elementos para una evaluación general del Sistema de Ciencia e Innovación Tecnológica.” (“Elements for a General Evaluation of the System for Science and Technological Innovation.”) December 20, 2004.

*Document 4.* Ministry of Science, Technology, and Environment (CITMA). “Estrategia Nacional de Ciencia, Tecnología e Innovación 2008–2010.” (“National Strategy for Science, Technology and Innovation, 2008–2010”). Draft. 19p, 2007.

*Document 5.* Ministry of Science, Technology, and Environment (CITMA). “Áreas de prioridad para la investigación científica y la innovación 2008–2015.” (“Priority Areas for Scientific Research and Innovation.”) 2008.

A list of problems identified in each of the documents was made and then a synthesis of the problems that appeared with some frequency in all of the materials was developed. The subsequent analysis revealed that types of problems could be organized into two groups. One group related to issues of a *structural* nature, and the other involved difficulties with *financial resources*. Following is a description of the problems:

### ***Weak Interaction Between R&D and Production and Insufficient Demand from the Business Sector to the Research Sector***

With some exceptions in the medical-pharmaceutical sector, the assessments do not reveal significant innovative behavior among businesses. Essentially, innovation continues to be seen as the introduction of outputs that research entities are responsible for.

Thus, despite the declarations contained in SCIT documents, R&D continues to occur predominately outside of business enterprises. With some exceptions, Cuba does not have “*Shumpeterian*” businesses that undertake internal R&D. The logic of the linear model long in use is one of the reasons that businesses do not internalize R&D. Similarly, technology management is unable to guarantee effective links between R&D and production, since entities specialized in infrastructural services have concentrated on organizational development work, and have paid less attention to technology management.

Some of the results from the 1st and 2nd National Innovation Surveys (in 2004<sup>10</sup> and 2006) reflect this problem. For example, according to Chía, J. 2004 some of the conclusions from the first survey indicate that:

- *There are no regular and systematic links to the scientific sector: research centers and universities.*
- *Cuban businesses typically adhere to a traditional concept of incremental innovation that does not encompass technological change; rather, it is associated with solving practical problems to maintain production and services.*
- *Innovation is considered an activity reserved for the Forum on Science and Technology and the National Association of Innovators and Rationalizers (ANIR). It is not generally part of the vision of directors for improving the economic efficiency of enterprises, increasing competitiveness and making it into a decisive factor for technological change.*

Similarly, some of the results from the second survey indicate that:

- *The relationships with the scientific sector as well as the institutions that develop linkages continue to be irregular and unsystematic.*
- *Among surveyed firms, innovations in organization are given the most weight.*
- *Firms are still not fully taking advantage of their capacities to introduce goods and services, processes and organizational changes.*

### ***Organizational Difficulties Related to Technology Transfer and the Lack of Evaluation and Approval Criteria and Procedures for Technology Transfer***

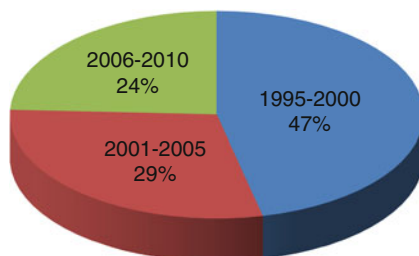
An issue that is still pending on the STIP agenda is the formulation of a technology transfer policy. Given the lack of an explicit policy for technology transfer, transferred technologies were essentially determined by government decisions tied to international trade and investments. Exempt from any regulatory policy oriented

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<sup>10</sup>The first survey included about 600 state enterprises, trade associations and mixed enterprises in industry, construction, transportation and communications with more than 200 employees and significant weight in their respective sectors. The survey was based on an adaptation of the Oslo methodology and included data from 1997 to 1999.



**Fig. 9.13** Legal instruments by time period, 1995–2010 (%). *Source:* By authors



toward locally developed technologies, agencies and productive firms tended to increase technology imports. This undoubtedly limited the means for strengthening national technological development, in addition to restricting the possibilities for disaggregating the “technological package.”<sup>11</sup>

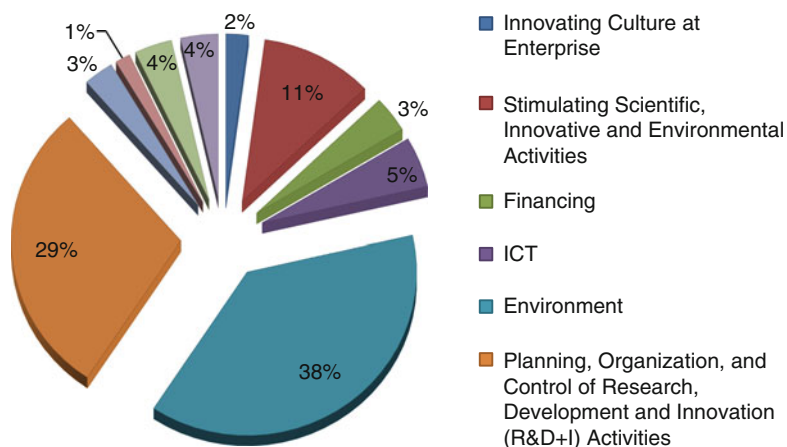
### ***Insufficient Legal-Methodological Basis of the SCIT***

It is broadly accepted that stated policy can be limited to a simple declaration of intentions if it is not implemented through the necessary channels to become concrete actions and achieve its potential impact in practice. What are the outputs we want to achieve? Through what means? These are the key questions that the policy must address, and to do so it is important to consider *policy instruments*, among other factors.

A more detailed look at the policy instruments beginning in 1995 that were designed to structure, regulate and try to articulate the SCIT reveals some interesting characteristics. An analysis of legal mechanisms from 1995 to 2010<sup>12</sup> reveals that most active period for the design and implementation of regulations was between 1995 and 2000; 46 % of the total corresponds to those years (Fig. 9.13). The 2001–2005 period generated 29 % of total regulations and only 24 % registered from 2006 to 2010. This trend in implementation indicates that in the mid-1990s, when the establishment of the SCIT was announced, there was greater effort placed on creating legal mechanisms for structuring the system, especially during 1996 and 1998. Moreover, approximately 76 % of the System’s legal instruments were created between 1995 and 2006.

<sup>11</sup>“Disaggregation of the technological package” refers to the determination of the technology needs that can be met through investment in the productive sector and through R&D. See also: Sáenz and Capote: *La tecnología y la política científica y tecnológica en Cuba*, 1988, pp 69–121.

<sup>12</sup>These mechanisms include Laws, Decrees and Resolutions issued by the National Science and Technology Body alone and jointly with other agencies. The search was conducted through 2010, which meant that it was not possible to include all the legal mechanisms with direct influence on STIP. Nevertheless, the mechanisms identified were sufficient to reach conclusions about developments in different periods of time as well as aspects of the System that they related to.



**Fig. 9.14** Legal instruments by areas, 1995–2010 (%). *Source:* By authors

A breakdown of these instruments by area is provided in Fig. 9.14, which identifies 10 areas directly linked to R&D, innovation activities and system functioning, along with the relative number of instruments designed for each area. The largest area is “Environment” with 38 % of the regulations, followed by “Planning, organization and monitoring of R&D and innovation activities,” with 29 % of the identified instruments. In the latter, of the 41 instruments identified, 12 are related to programs and projects that are the equivalent of almost 30 %. This indicates that to a certain extent the hallmark of the STIP has been the design of legal regulations related to programs and projects. The areas with the least amount of regulatory action are “Intellectual property” with 1.4 % and “Innovation culture in firms,” with 2.1 % of the total.

### ***Insufficient Foreign Currency Financing***

Investment in science and technology is one of the fundamental activities of national innovation systems. In highly articulated and developed economies like some capitalist countries, investment in R&D as a percentage of GDP is an indispensable indicator for developing the so-called knowledge economy; in several of those countries the investment level is greater than 3 %.

According to UNESCO’s Science Report 2010, Cuba’s total expenditure on R&D has declined, and is now below the regional average. In recent years, business financing has fallen by half and makes up barely 18 % of the Gross Expenditure in Research and Development (GERD).

The Cuban government’s policy of preserving and supporting the R&D sector has meant that despite the severe economic restrictions that arose in the 1990s, the

institutions continue functioning with their existing resources. State support for financing R&D has covered salaries and other expenses in Cuban pesos. However, the inability to meet the foreign currency needs of all the R&D institutes, universities and firms, among other actors in the system, has led to significant difficulties obtaining materials, specialized supplies and equipment.

Finding a viable means of obtaining foreign currency for the System is a challenge that must be dealt with. The problem of financing research is not limited to the research institutions and universities; it also exists in the business sphere. Thus, it will be necessary to create organizational forms that promote the articulation of financial flows among research entities, universities, businesses and society as a whole.

### ***Insufficiencies in Scientific-Technical Information: Limitations on Access to National Information Networks and to the Internet***

The country's strained finances have also led to problems with maintaining specialized information and with access to national information networks as well as to the Internet.

For example, with respect to maintaining information, according to the Cuban Science and Technology Observatory (2004), at the end of the 1990s a national information policy to be coordinated among nearly all Central Administration (OACEs) agencies was formulated. In mid-2001, this policy was finalized as the "National policy for information and knowledge management." However, it has not been possible to adequately implement the policy.

The country's economic problems and the U.S. embargo underlie Cuba's difficulties accessing the Internet. Problematic access to the Internet and to national information networks puts the scientific, university and business communities in a disadvantageous position.

Nevertheless, the UNESCO Science Report 2010 indicates that Cuba was able to increase access to the Internet from 2 % of the population in 2006 to almost 12 % 1 year later.

## **Toward a New Science, Technology, and Innovation Policy**

As noted above, groups composed of experts, representatives of ministries and social organizations are working on developing recommendations based on the provisions in the Guidelines. The evaluation of the STIP offered above provides a basis for understanding some of the problems that the new policy provisions must address.

Chapter V, "Science, technology, innovation and environmental policy" outlines the basic ideas for deploying human capital and knowledge and innovation capacities.

The Guidelines in this chapter are the result of a public debate that led to the modification of 100 % of the Guidelines proposed (the overall rate of modifications was 68 %). The initial version proposed 7 Guidelines and the final document includes 11.<sup>13</sup>

The Guidelines declare the necessity of developing a new STIP. According to Guideline 129 in Chapter V, it is necessary to: “Design a comprehensive policy for science, technology, innovation and environment that considers their accelerating rate of change and growing interrelationship in order to meet the development needs of the economy and society in the short, medium and long term; and that is oriented toward improving economic efficiency, expanding high value added exports, import substitution, meeting the needs of the population and promoting their participation in the construction of socialism, and protecting the national environment, patrimony and culture.”

Putting this policy into effect is an extraordinary challenge. A better and bigger role for science, technology, and innovation is expected in the new development model. A comparison of the initial proposal for Chapter V with the final approved version reveals some differences, such as:

1. The final policy is more comprehensive, in that in addition to economic impact, it relates STIP to social participation, environmental protection and the preservation of patrimony and culture. This formulation incorporates the importance of research in the social sciences and humanities and emphasizes their importance in decision-making.
2. The initial project did not stress the role of universities, but the approved version permits universities to make legal and organizational changes to strengthen the connection between research and innovation. Universities have been proposing this objective for decades (Núñez 2010) but the institutional and legal bases were not created. Precedents privileging the “social objective” of universities contradicted this objective. The Guidelines open the possibility of introducing the necessary changes.
3. The fields that merit priority attention are expanded: basic sciences and renewable energy, among others. These changes encourage more strategic research projects, where universities play a critical role.
4. Technological policy is emphasized and—without using the term—mention is made of the importance of evaluating technologies. This addresses a significant deficiency in previous policy formulations.
5. There is a more comprehensive approach to food production: rather than “agricultural” sector, the policy refers to the “agroindustrial” sector and goes beyond the traditional approach of “introduction of outputs” from science and technology into agriculture, toward the integrated management of the entire chain of production. This is important because the concept of “introduction of outputs”

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<sup>13</sup> See the document from the VI PCC Congress, “Información sobre el resultado del debate de los Lineamientos de la Política Económica y Social del Partido y la Revolución” (Information on the debate over the Guidelines for Economic and Social Policy of the Party and the Revolution), May 2011.

comes from a STIP model based on the “push from science” of previous policies that has been superseded by contemporary theories of innovation.

6. To a greater extent than the initial proposal, Chapter V stresses the importance of integrating science, technology, and innovation activities into the operations of firms, and assumes the necessity of creating regulations that will permit this. As discussed below, the current policy has failed in this important area.
7. The final Guidelines emphasize training professionals and managers to anticipate scientific and technological development and provide for the role of worker collectives to solve technological problems.

In our view the changes made were substantive and favorable, which shows the importance of public debate on issues of significant relevance such as STIP.

## From the Guidelines to Policy: Some Problems to Resolve

Some of the problems presented by STIP, such as the availability of financial resources and investment, will require time to resolve. Nevertheless, the journey from the Guidelines to policy also involves the proper solution to some conceptual problems.

First, it is important to overcome the *cognitive model* that has been hegemonic in Cuban science and technology policy for the past 50 years: the linear model based on the “push from science.”

Recent work from the Brazilian Center for Management and Strategic Studies (CGEE 2012) calls attention to the importance of choosing the proper approach for designing policies for Innovation Systems. According to this study, Innovation Systems in reality follow one of two different models. These models have consequences for the design of public policies and the role of universities in innovation. Following is a brief review of this paper, which will shed light on alternatives that are currently under debate in Cuba.

The first model restricts Innovation Systems to R&D activities and their associated infrastructures. Consequently, the mechanisms deployed include promotion of R&D activities, university-firm linkages and creation of technology-based enterprises. It frequently privileges the manufacturing sector and technological developments in pioneering areas: biotechnology, nanotechnology, etc. This practice has generated the so-called “paradoxes of innovation,” meaning that the emphasis on these policies is not having significant impact on innovation.

The second model adopts the ideas of Innovation Systems in a broader sense. Without negating the importance of R&D, it focuses on the acquisition and utilization of productive and innovative knowledge and training. In this perspective the concept of Innovation Systems encompasses the collection of organizations that contribute to innovation capacity-building in a country, region, sector or locality. It is made up of elements and relationships that interact in the production, dissemination and use of knowledge.

Learning is considered a key vehicle of innovation. Thus, to innovate is to learn to produce and use new knowledge or to learn to combine and use existing knowledge in new ways to address old and new problems. This perspective assumes that innovation is an interactive phenomenon in which social, political, institutional and cultural factors converge. It affirms the interdependent nature (activities through networks) rather than linearity in innovation processes.

This model suggests a broader approach to innovation systems than the traditional Cuban system. These systems are not limited to the science and institutions that the Cuban System has predominately focused on. Building innovation systems based on science, technology, and innovation policies is not an exclusive issue for scientists and their institutions. A strong network among universities, research centers, governments at all levels, legal frameworks, and the educational system is required, all of which promotes systematic interactions among actors involved in innovation. This is the conceptual change that is perhaps the most important aspect of establishing a new STIP.

There are also other important questions. The systematic perspective that we advocate necessitates a multidisciplinary and intersectoral approach. It is not an issue that is attributable to any one particular ministry. Moreover, STIP in Cuba has been “top down” more than “bottom up.” Currently, Cuba needs a broad debate supported by the greatest possible social participation. The significant enrichment of the Guidelines from their initial proposals to the final version indicates the importance of social participation in the debate over STIP.

Another issue that must be considered is that the STIP should include the non-state sector, a factor that is missing from Chapter V of the Guidelines.

The STIP also requires a territorial approach, not just a sectoral or national level focus, which has been the primary approach in previous STIPs. Efforts at developing local and territorial systems are needed.

The issue of human capital, especially in the sciences and engineering, as well as agricultural sciences, seems to be a measure of great significance. This involves not just the training of personnel; it also includes retention and appropriate promotion of their activities.

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# Chapter 10

## Foreign Direct Investment in Vietnam and Cuba: Lessons Learned

Omar Everlenny Pérez Villanueva

### Introduction

Since the late twentieth century, foreign direct investment (FDI) has been a central element of economic globalization. FDI leads to increases in domestic capital in most recipient countries, but given its impact on economic growth, its contribution to domestic capital formation may be more important than what global figures suggest.

The essence of the argument that capital inflow benefits a recipient country assumes that the recipient's increased income exceeds that of the investor; in other words, as long as FDI leads to an increase in the national product and this increase does not exclusively go to the investor, the recipient country will benefit. Such benefits may be enjoyed by domestic workers through higher real wages, by consumers who pay lower prices or receive better quality products, and by the State, which gains greater access to financial flows and new technologies, as well as increased tax revenues and the potential to increase exports of goods and services.

Developing countries typically need all forms of external financing, and Cuba is not immune from this necessity. However, Cuba, unlike other countries, has no access to multilateral sources of financing, and bilateral credit is limited due to the external indebtedness of the Cuban economy.

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In the late 1980s, given the disappearance of its traditional sources of financing, and the inability to reactivate short term bilateral and multilateral credits, Cuba reconsidered its policy on foreign capital investment, expanding FDI's role in the economy. Yet because of numerous factors this dynamism was not sustained. Given Cuba's unfavorable macroeconomic indicators, and the technological deterioration and obsolescence of its productive capacities, an analysis of Vietnam's positive experience with foreign capital may prove valuable for application to the Cuban case, as reflected in the document guiding future changes in the Cuban economy, *Guidelines of the Economic and Social Policy of the Party*.

### ***FDI in Vietnam***

Vietnam is among the developing economies that have performed well in recent years. It is currently undergoing a massive transformation, and although it remains a planned, socialist, and self-sufficient economy, steps are being taken to make it market-based. It has the potential to be a successful model for development and the role played by foreign capital in this part of the world.

In the 1976–1987 period, Vietnamese economic growth had been limited by a number of factors, including excessive centralization and planning, inadequate management mechanisms, the US economic blockade, and high defense spending, among others. In the mid-1980s, Vietnam's economy had slow growth and suffered from hyperinflation, despite considerable assistance from the socialist countries (World Bank 1996).

After the country's reunification in 1975, Vietnam was considered one of the world's poorest countries, with a per capita income below 200 USD. In this context, a number of reforms were made in an effort to eradicate poverty and address long-standing obstacles such as underdevelopment, the consequences of the war, the US blockade, and border problems with neighboring countries.

In 1986, as a result of the 6th Congress of the Communist Party of Vietnam, the economy began to undergo significant changes with the introduction of reforms including the implementation of market mechanisms and economic restructuring. Factors such as the lifting of the blockade by the United States supported the implementation of reforms.

For example, in 1986 the authorities embarked on a reform program (*Doi Moi*) that started with small changes in the rural sector. The development strategy was intended to establish a *socialist-oriented market economy* capable of fitting into the dynamics of the global economy, to seek solutions to economic and social challenges, and to find alternative sources of funding to carry out the new strategy. The country was able to adjust to the collapse of the Council for Mutual Economic Assistance (CMEA) and the loss of Soviet aid without reducing production.

In a short time the reforms dismantled collective farms—reestablishing a system of family farms in the countryside, most prices were deregulated, the creation of new private companies was authorized and encouraged in several fields, trade and

investment regimes were liberalized, the exchange rate was unified, fiscal deficits were reduced, and financial discipline was imposed on state-owned enterprises. As a result of these measures, since 1991 economic growth has been around 8 %.

Vietnam began to rapidly integrate into the world economy mainly due to a substantial increase in the production capacity generated by economic restructuring, and reforms in institutions, development policy and management of the economy.

In 1988, the National Assembly adopted a policy of openness to the external sector and the first foreign investment legislation. Implementation of the economic reform plan prepared by the Vietnamese authorities was initiated in 1989. The plan was discussed with experts from the International Monetary Fund (IMF) although Vietnam was not a member at the time, since creditor countries continued to demand payment. Vietnam agreed to pay US\$50 million, which was partially advanced by France and Japan.

Legislation protecting private property was approved and a new Constitution was adopted in 1990. In 1993, the Land Reform Act was passed, granting peasant families land-use rights for 20 years and in some cases up to 50 years.

The state monopoly on foreign trade was eliminated in 1991, facilitating trade with foreign companies. New sources of financing were sought through the development of policies favoring savings and investment, such as capital market development, higher interest rates, and individual hard currency savings in commercial banks. The country's external debt was renegotiated, and links with international agencies and financial institutions were activated, including the IMF and World Bank, and the country joined ASEAN.

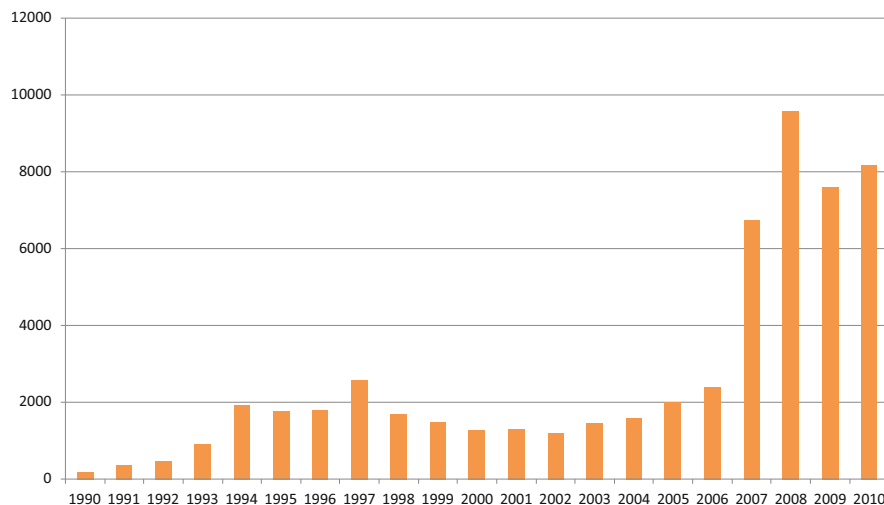
Beginning in 1986, export growth in Vietnam increased to over 25 % a year. While domestic companies were mostly responsible for this growth, FDI played an important role by providing capital, technology, business management know-how and market access, and other less tangible benefits, such as new ideas.

In Vietnam FDI is viewed as a process controlled by the State to obtain capital and advanced technologies, and introduce new forms of business management to help improve production efficiency and quality. Combined with a more rational use of existing strengths and resources, the FDI process is designed to be consistent with the country's strategy for economic and social development.

The policy implemented to attract investment has enabled an increasing flow of capital. Thus, while very low figures were recorded in 1990, 6 years later FDI had exceeded \$2 billion USD annually, and currently exceeds \$8 billion a year, as shown in (Fig. 10.1).

The first FDI law was approved after Vietnam opened in 1987, and two amendments were subsequently enacted, in 1990 and December 1992, that added new forms of investment, extended the term for partnerships and introduced changes facilitating greater openness and flexibility for the foreign investment process.

Additionally, rules and regulations implementing the law were issued that covered basic forms of investment, contractual partnerships, joint ventures, wholly foreign-owned enterprises, companies operating in Export Processing Zones (EPZ's) and build-operate-transfer contracts.



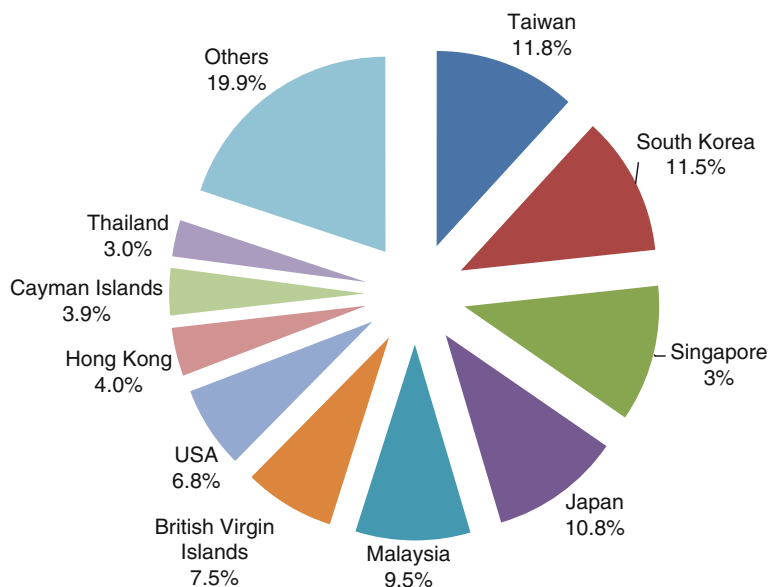
**Fig. 10.1** Foreign Direct Investment in Vietnam, 1990–2010 (millions USD). *Source:* UNCTAD (2011) Report on the World Investment 2011 Non-Equity Modes of International Production and Development. Overview. New York

**Table 10.1** Foreign Direct Investment Projects in Vietnam, 1988–2010

	Number of projects	Registered capital (millions of USD)
Total	13,544	213,025.0
Manufactured goods	7,860	93,660.7
Real estate, leasing	1,894	52,348.3
Mining and extractive	130	10,982.5
Hotels and restaurants	412	19,711.6
Construction	662	9,699.0
Transportation, warehouses, and communications	570	9,314.4
Agriculture, forestry, and fishing	749	4,397.7
Electricity, gas, and water	78	5,184.1
Recreation, culture, and sports	134	2,874.2
Health care and social work	78	1,037.4
Financial services	70	1,162.8
Wholesale and retail	447	1,439.6
Education and training	133	388.5

*Source:* Ministry of Planning and Investment, Foreign Investment Agency in Vietnam and Statistical Handbook for Vietnam, 2011. Hanoi, Vietnam

FDI has grown the fastest in the manufacturing sector, which accounts for 50 % of total investment. Equally important are real estate and mining projects and the role of investment in services, as well as increased investment in transportation, mail service and communications in general and tourism (Table 10.1).



**Fig. 10.2** Foreign Investment in Vietnam, 1990–2010. *Source:* Ministry of Planning and Investment, Foreign Investment Agency in Vietnam and Statistical Handbook for Vietnam, 2011. Hanoi, Vietnam

From 1990 to 2010, Taiwan, South Korea, Singapore, Japan, Malaysia, British Virgin Islands, USA, Hong Kong and Thailand were the principal sources of foreign investment in Vietnam (Fig. 10.2).

Similar to China, regional distribution of investment projects is not very equitable, with the Southeast, Central North and North Central Coast regions, and the Red and Mekong River deltas absorbing 90 % of the invested capital. Nevertheless, in 2010, with the exception of investment in oil and gas, around 58 regions benefited from direct investments of foreign capital. The most attractive place was Ho Chi Minh City, followed by Ba Ria, Vung Tau, and thirdly, Hanoi, the capital city.

Levels of FDI are asymmetrical between North and South Vietnam due to pre-existing levels of development, which were in place even before the United States intervention, in which the South's Saigon regime was backed by USA.

## Economic Development Zones Based on FDI

With the establishment of Special Economic Zones (SEZ's), Vietnam sought to promote the industrial sector and, in turn, attract more FDI to these areas, using tax and non-tax incentives. The ways in which an SEZ can be established in Vietnam are the following:

- *Economic Zones*: economic areas with defined geographical boundaries, separated from the general investment and business environment, and with favorable conditions for investors.
- *High-Tech Parks*: areas with defined geographical boundaries that specialize in research, development and high-tech applications.
- *Industrial Zones*: areas with defined geographical boundaries that specialize in manufacturing for export and related services.
- *Export Processing Zones (EPZ's)*: industrial zones that specialize in manufacturing for export and related services.

According to the Investment Law, Decree 29/2008, these areas can only be authorized by the Prime Minister. All of the SEZ's enjoy tax incentives to attract foreign capital, such as the elimination of all restrictions on exports.

Driven by the overheated Chinese economy, numerous industrial plants have been established in Vietnam. Japanese and Korean companies have been attracted to newly created segmented parks and Malay-Vietnamese capital has invested in high-tech companies. Vietnamese free-trade zones have shown impressive growth, expanding from one park in 1991 (100,000 employees) to over 150 in 2009 (1,000,000 employees). More than 40 % of the total FDI in the country goes to free-trade zone projects.

### ***Legal Regime Covering Foreign Investment***

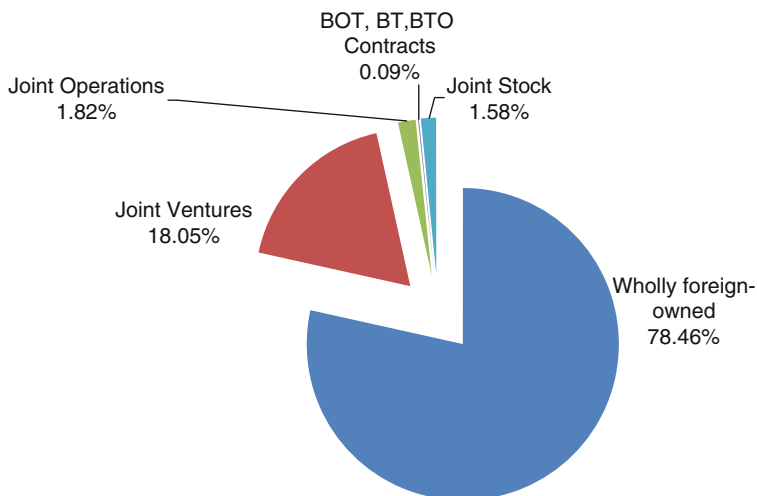
The first Foreign Investment Law, enacted by Vietnam's National Assembly in December 1987, established that the Socialist Republic of Vietnam welcomed and encouraged foreign and domestic organizations to invest capital and technology in Vietnam within the rubric of respect for national sovereignty and independence, full compliance with Vietnamese laws, equality and mutual benefit Vietnam (2006).

In the mid-1990s there was a massive influx of foreign direct investment, which made it necessary to revise and improve the law, leading to the introduction of Decree No. 24/2000 in July 2000 and Decree No. 27/2003 on March 19, 2003. In 2005, the National Assembly adopted the *Common Investment Law* that went into force in July 2006, which provided for equal treatment of foreign and domestic investors in the country. Under this Act, the State guarantees respect for property rights on capital invested. Moreover, foreign direct investment is encouraged in all sectors of the economy, except for those involving national security, public interests, the environment and historical and cultural heritage.

According to Article 4, Chapter II, foreign investors can conduct their operations as follows:

#### 1. Joint venture:

Company established in Vietnam by two or more parties, based on a joint venture contract or an agreement signed between the Government of the Socialist Republic of Vietnam and a foreign government, or constituted by a company



**Fig. 10.3** Foreign Investment in Vietnam, Types of Investment, 2010. *Source:* Ministry of Planning and Investment, Foreign Investment Agency in Vietnam and Statistical Handbook for Vietnam, 2010. Hanoi, Vietnam

with foreign investment capital and a Vietnamese company, or a joint venture in cooperation with foreign investors under a joint venture contract.

2. Wholly foreign-owned company:  
Company established in Vietnam with 100 % capital invested by the foreign party.
3. Business cooperation based on one of the following types of contract:
  - (a) *Build-Operate-Transfer Contract (BOT)*  
Document signed by a relevant State agency in Vietnam and the foreign investor for the construction and commercial exploitation of an infrastructure project for a given period. Upon expiry of this period, the foreign investor transfers the infrastructure without compensation to the State of Vietnam.
  - (b) *Build-Transfer-Operate Contract (BTO)*  
Document signed by a relevant State agency in Vietnam and the foreign investor for the construction of an infrastructure project. Upon completion of construction, the foreign investor transfers the infrastructure to the Vietnamese State and the Vietnamese government grants the investor the right to commercial exploitation for a specified period so that the investment can be repaid and a reasonable profit can be obtained.
  - (c) *Build-Transfer Contract (BT)*  
Document signed by a relevant State agency in Vietnam and the foreign investor for the construction of an infrastructure project. After the construction, the investor transfers the infrastructure to the State of Vietnam and the Vietnamese government creates the conditions for the investor to perform other projects so that the investment can be repaid and a reasonable profit can be obtained (Fig. 10.3).



The State of Vietnam does not allow foreign investment in sectors and regions that can harm national defense and security, historical and cultural relics, traditions and morality, and the environment.

Based on its development planning and guidance for each period, the government designates regions for investment promotion and issues a list prioritizing investment projects. Vietnamese private economic organizations can cooperate with foreign investors in sectors and under the conditions established by the Government.

In principle, investors can develop any type of investment project. However, there are areas in which certain forms of investment are not allowed, and others in which it is only allowed in the form of a joint venture or cooperation agreement.

The establishment of foreign capital is limited to joint ventures or business cooperation contracts (BCC) in the following areas:

- Mining, oil refining and gas, and mineral extraction.
- Air, railway and maritime transportation, public transportation, airport and port construction (except when the method is BT, BOT, BTO).
- Air and maritime services.
- Certain forms of reforestation.
- Tourism activities and travel agencies.
- Production of industrial explosives.
- Legal consultancy services (nontechnical).
- Culture, excluding technical document printing, packaging and labeling of goods, clothing, textiles or footwear, sports and entertainment and computer-animated cartoon production. Culture encompasses not only art, performing arts and entertainment but also advertising in general.

Investment in the form of a BCC is allowed between one or more foreign parties and a Vietnamese party—a specialized unit authorized to conduct business—in the following sectors:

- Establishment of public telecommunications networks, telecommunications and mail services (express, domestic and international).
- Media-related activities, radio and television.

Under the Common Investment Law, participation is limited to 30 % in those sectors and areas determined by the authorities. Thus, Vietnamese companies are limited to a maximum of 30 % of equity capital in some sectors.

With the renewal of the *Bankruptcy Act* (June 15, 2004), bankruptcy proceedings were simplified, allowing for the participation of other affected parties (non-creditors), and granting courts greater flexibility to deal with insolvency. Under this law, many inefficient enterprises and organizations can be closed down.

*Land Law* No. 13/2003/QH11—substituting for the July 14, 1993 law, it upheld the principle that title to the land belongs to the people, and the State (Government and People’s Committee) is solely entitled to administer it. This law established regimes for authorized use, the rights and obligations of beneficial owners and administrative procedures for use, management and inspection.

*Decree No. 181/2004/ND-CP* of October 29, 2004 on the implementation of the Land Law clarifies administrative procedures, opens residential real estate to foreign investment, and addresses other matters related to land pricing.

The *Ministry of Planning and Investment* (MPI) is responsible for coordinating central and local government bodies that evaluate proposals and grant investment licenses. It is also responsible for monitoring approved projects' compliance with their license requirements, as well as improving the legal framework for foreign investment in Vietnam.

Wholly foreign-owned enterprises must operate as limited liability companies; the nonresident owner may accredit a duly authorized representative in Vietnam. Companies operating in EPZ's, which are limited liability companies, provide support services for export manufacturing and are themselves exporters.

Build-operate-transfer contracts are used to attract large amounts of capital, mainly for building infrastructure. Under these contracts, foreign investors construct and operate infrastructure works, and once the investment is recovered and a profit margin is earned, it becomes government property, without the government disbursing funds as part of the operation.

Notably, participation in FDI is restricted for native Vietnamese residents in the country, but there are no restrictions on foreign investors, except for immigrants with pending criminal cases. However, participation of Vietnamese living abroad is encouraged as their contribution to national reconstruction.

*There are different approval processes* depending on the value of the agreements and the areas contemplated for investment. There are three investment groups, A, B and C.

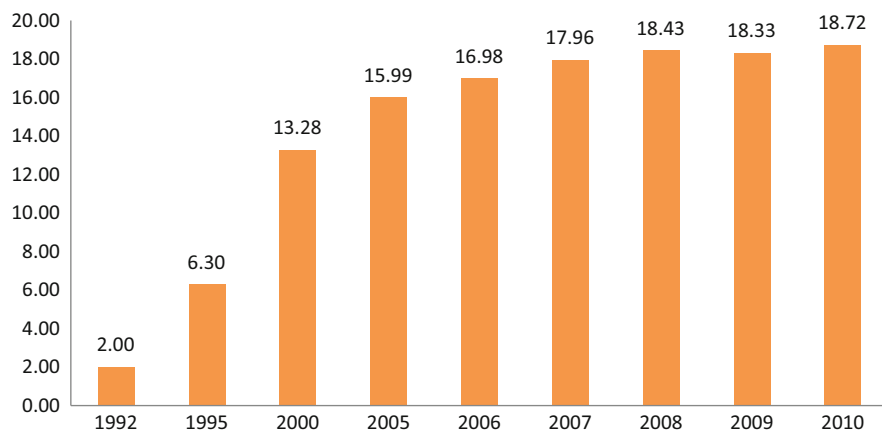
The *contract period* can be up to 50 years, but if necessary can be extended to 70 years with government authorization and the approval of the State Council. The law requires that Vietnamese citizens be given priority in the recruitment of personnel for joint ventures. Foreign hires are only permitted for jobs with high technical qualification requirements not available among nationals. A specialized employment agency is in charge of recruitment for foreign companies.

*Tax regime.* Companies with foreign capital investment and related foreign individuals or organizations pay a 15–25 % tax on profits. If profits are reinvested for 3 or more years, the company will be reimbursed the amount equivalent to the tax paid for reinvested profits.

Exemption from this tax can be granted for a maximum period of 2 years after the enterprise becomes profitable; this exemption depends on the investment area, the capital contributed, the exports resulting from the business, and its nature and duration.

Companies must also contribute to Social Security at a rate of 10 % of payroll.

Foreign individuals or organizations are also required to pay a tax on profits remitted abroad, depending on their contribution to the company. Domestic or foreign workers employed in any foreign investment company pay personal income taxes according to Vietnamese tax law. They also pay 10 % of their salary as a contribution to the local social security fund, in addition to the contribution made by the employer.



**Fig. 10.4** Proportion of FDI Contribution to GDP (in percent). *Source:* Based on statistics provided by MAI THI THU, MSc. National Center for Socio-Economic Information and Forecasting, Ministry of Planning and Investment, Vietnam

Guarantees are offered to foreign investors to repatriate their share of business profits, technological transfer payments or other services. Permission is granted to foreign investors and workers to buy houses during their stay in Vietnam.

Recently, Vietnam has been viewed as an alternative to China, with its low-cost labor, sound and efficient infrastructure, competitiveness and stable environment, which helps attract foreign investment flows.

As a result of the Vietnamese reform process, economic indicators are positive where FDI is constantly increasing. FDI's impact on job creation has been similarly robust, with over two million jobs created by 2011, compared to only about 400,000 a decade before.

A period of recovery began after 1991, in which the average growth rate reached 7.5%. Significantly, economic growth accelerated during the exact same period that trade relations with the former socialist countries experienced the most acute deterioration, even though those relations accounted for 46.3% of exports and 73.5% of imports in Vietnam. Courbet (1987).

Real income has increased by 7.3% annually over the past 10 years. In 1993, when the World Bank resumed operations in Vietnam, per capita income was US\$170. In 2007 it reached \$620 and by 2010 it was \$1,000. World Bank (2009).

According to Vietnam's General Statistics Office, industrial growth in 2008 was 8.7% in the state sector, 24.1% in the non-state sector, and 20.9% in foreign investment for industrial production. The foreign investment sector has ultimately accounted for 37.2% of Vietnam's industrial output and 57.4% of total exports (Fig. 10.4).

As in the case of China, transition to a competitive market economy is driving Vietnam's growth. This is due to *private companies, which were insignificant in 1993, but now account for over 47% of annual investments*. In recent years, state-owned enterprises have also grown, despite internal and external competition. More

than 75 % of state-owned enterprises are profitable, with rates of annual return on capital between 7 and 8 %.

There is no doubt about the country's economic achievements. But other problems persist, such as underdeveloped financial markets, weak competitiveness in the domestic market, and a growing imbalance in income distribution, which is widening the gap between higher-and lower-income sectors.

### Some Considerations

This Asian economy has achieved a very high level of development as well as a significant share of foreign capital, either as a source of financing or in other forms, which contributes to the economy's growth and development. Of course, policies developed by counterparty governments also have a substantial influence, as well as incentives that can be offered to investors in order to attract higher investment levels.

Although the Republic of Vietnam is a communist country, the central government and party have sought to create a competitive economy at the international level that takes the form of a socialist market economy. Since the beginning of the *Doi Moi* in the 1980s, openness and economic integration with the region ASEAN in 1995 and the rest of the world WTO in 2007 have been given priority.

Compared with the three major powers in the region (Japan, India and China), Vietnam's economic importance is small, but in recent years it has become the fastest growing economy after China. Additionally, the country plays an important role in the industrial off-shoring schemes managed by the most advanced East and Southeast Asian countries. The government has improved social conditions, which has resulted in a reduction of unemployment and poverty levels, but it has not yet committed to reducing the high levels of corruption that are still prevalent. As for investments, Vietnam established equal treatment for foreign and national investors, decentralized certification processes to the provincial level, and focused on reducing pollution levels generated by domestic and foreign companies.

In order to improve investment policies implemented under the *Doi Moi* and create more favorable conditions for (foreign and national) investors, the government should, among other things, provide greater flexibility to investors in general as long as no laws are violated; regulate investment and protect national interests through specific laws and relevant regulations; simplify both the registration of foreign investments and certification procedures; and update the list of restrictions on the entry of foreign investment in the decrees established by the Investment Act.

FDI in Vietnam is part of a comprehensively conceived system that is subject to continuous adjustments; it plays an important role in the economic performance of the country, with a high correlation among its indicators, although it cannot be considered a panacea for development.

The Vietnamese experience with FDI provides a basis for comparative analysis of the Cuban case. Despite differences with Vietnam, FDI flows to Cuba have not contributed to the economic growth and development as was hoped.

## Foreign Direct Investment in Cuba

Cuba's efforts to update its FDI policy in accordance with international requirements has managed to attract this type of investment to several sectors, however much remains to be done in terms of the legal framework and incentives to attract FDI. Cuba's FDI legislation is in Law No. 77 (1995) and Agreement 5290 (2004) of the Executive Committee of the Council of Ministers.

On April 18, 2011 at the Sixth Congress of the Communist Party of Cuba, the Guidelines of the Economic and Social Policy of the Party and the Revolution were adopted; provisions covering foreign investment included:

1. Ensure that while attracting foreign investment multiple objectives are met, including access to advanced technology, transfer of management skills, diversification and expansion of export markets, import substitution, supply of medium- and long-term external financing for production and working capital for its operation, and the generation of new sources of employment.
2. Promote the creation of Special Development Zones to support increased exports, effective import substitution, high-tech projects, local development and creation of new jobs.
3. Promote, where economically warranted and desirable, the establishment of companies and alliances abroad to best position Cuba's interests in foreign markets.

As a favorable destination for investment, Cuba continues to offer the same guarantees established in the 1990s, but according to many partners who have entered into contracts, this process has not been without difficulties and setbacks. However, the issues vary depending on the scope of the partnership, the area of operations, and the country concerned.

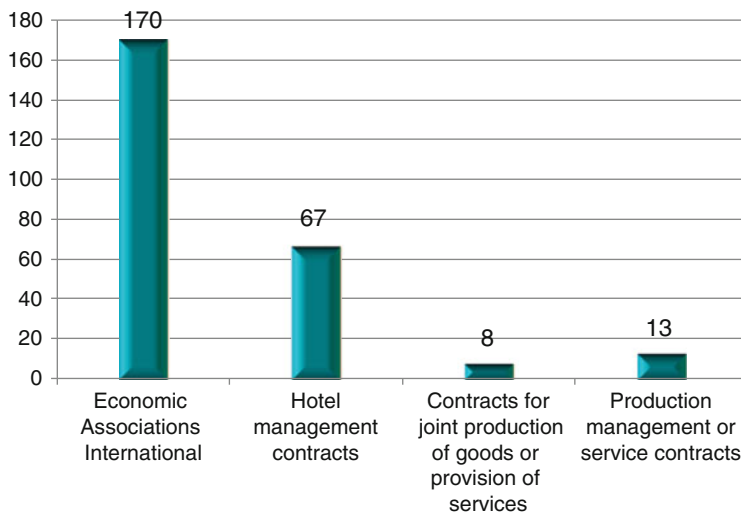
Among Cuba's advantages as an investment destination are the following:

1. Repatriation of tax-free dividends.
2. Income tax of 30 and 25 % of payroll.
3. Incentives are determined according to type of business, amount invested, and activity.

Cuba maintains strong bilateral relations, including a total of 62 agreements for reciprocal promotion and protection of investments with 71 countries and 11 agreements to avoid double taxation.

Article 12 of Act 77 contains the legal framework defining privileges and guarantees for foreign investors, labor and tax regimes, allowed applications for investment and company forms. It provides for the following types of entities:

- (a) Joint Ventures.
- (b) International economic partnership contracts, including insurance.
- (c) Wholly foreign-owned companies.



**Fig. 10.5** Total Businesses Involved in Foreign Direct Investment in Cuba at the End of 2011. *Source:* Estimates based on working documents from the Ministry of Foreign Trade and Foreign Investment. 2012. Havana

Agreement 5290 of the Executive Committee of the Council of Ministers, dated November 2004, created new forms of foreign investment that increased the possible range for FDI activity in the country, leading to greater international openness.

The following new types of contract are permitted:

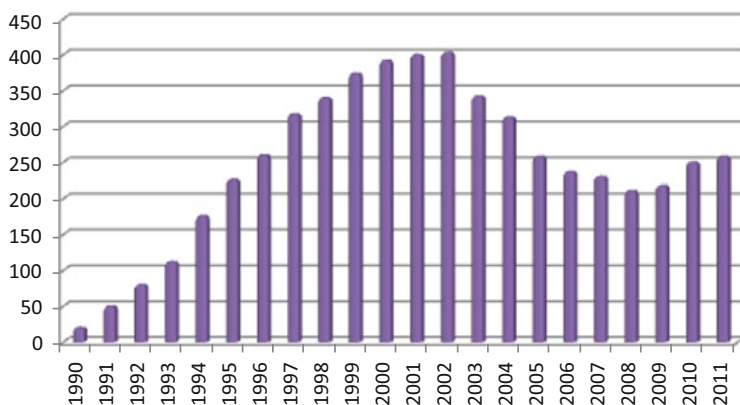
- (a) Hotel management contracts.
- (b) Contracts for joint production of goods or provision of services.
- (c) Production management or service contracts.

Generally these various forms of business in 2011 were distributed as shown in (Fig. 10.5).

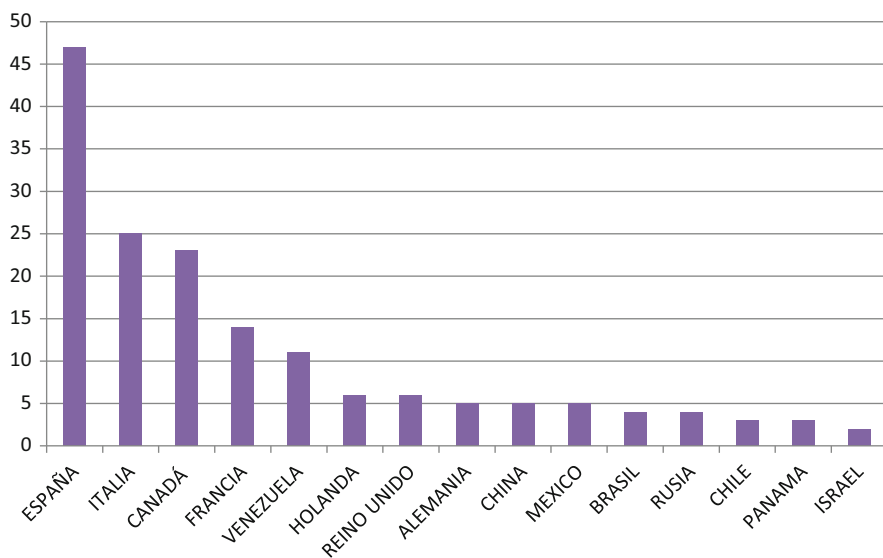
The number of Economic Associations with Foreign Capital (*AECE*) had been increasing until 2002, but beginning in 2003 there was a systematic decrease in their total number due to several factors, especially failures to comply with the approved lines of business, financial losses in some entities, failures to meet the agreed upon export target figures, and a shift to new foreign partners such as Venezuela, China and Brazil.

Beginning in 2010, the trend shifted away from a reduction in the relative number of these international associations, so that by 2011 the number of associations was similar to 2005. Figure 10.6 shows the overall trend away from creating international associations.

Cuba is subject to a foreign law that seeks to prevent the flow of FDI resources into the country, and has been assessed a “risk country” for foreign investment. Therefore, the foreign financing that reaches Cuba is of considerable importance to the economy, and has greater value than a qualitative comparison of nominal capital flows in the region may indicate.



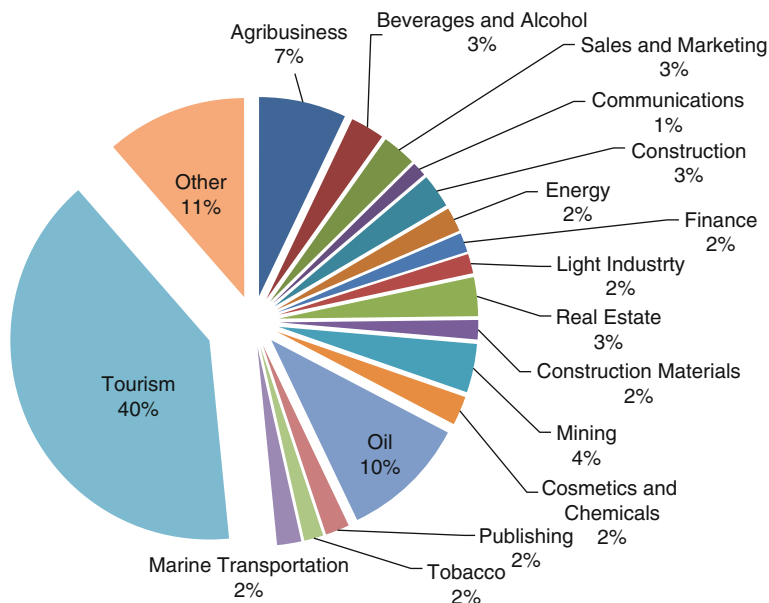
**Fig. 10.6** Number of International Economic Associations in Cuba 1990–2011. *Source:* Ministry of Foreign Trade and Foreign Investment. Annual Reports. Havana



**Fig. 10.7** International Economic Associations from Top 15 Investor Countries in Cuba in 2011. *Source:* Ministry of Foreign Trade and Foreign Investment. Annual Reports. Havana. Interviews with trade departments in the European Union, Latin America and China

Beginning in 2007, a large percentage of approved foreign companies originated with the Bolivarian Republic of Venezuela, and then other countries like Brazil were added. In general, Cuba's main foreign partners are Spain, Italy, Canada, France and Venezuela (Fig. 10.7).

By sector, the highest percentage of foreign investment is in tourism, oil and agribusiness, and to a lesser extent in other areas such as construction, transport and marketing. Given that one of Cuba's most important assets is human resources,



**Fig. 10.8** Percentage Share of Businesses According to Sector, 2011. *Source:* Ministry of Foreign Trade and Foreign Investment. Annual Reports. Havana

significantly, there is still minimal activity in high value added or high-tech areas. In recent decades developing countries that have gained a greater share of world trade have done so through strong investment in advanced or medium-range technologies (Fig. 10.8).

The presence of foreign capital in Cuba has been very positive, since despite decreasing numbers, the operating entities have reached a mature stage with positive results. For example, International Economic Associations (IEA) have steadily increased their indicators for total sales of goods and services, which in the first 9 months of 2011 totaled more than 4.556 billion pesos, exports grew to more than 3.005 billion, while the country’s direct income totaled about 561 million.

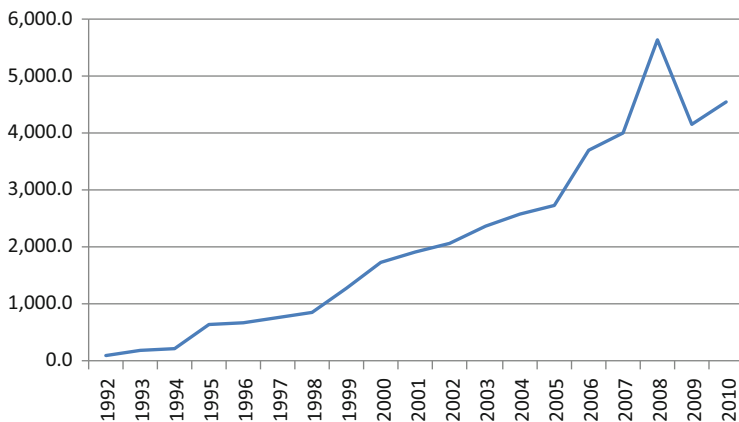
The government’s rigorous application of selectivity policy in foreign investment is reflected in fewer International Economic Associations annually; at the same time, basic economic indicators continue to rise.

Foreign companies’ sales are trending upward, with the exception of the drop in 2009; the highest percentage is found in oil production, communications services, and nickel, beverage and tobacco sales, among others (Fig. 10.9).

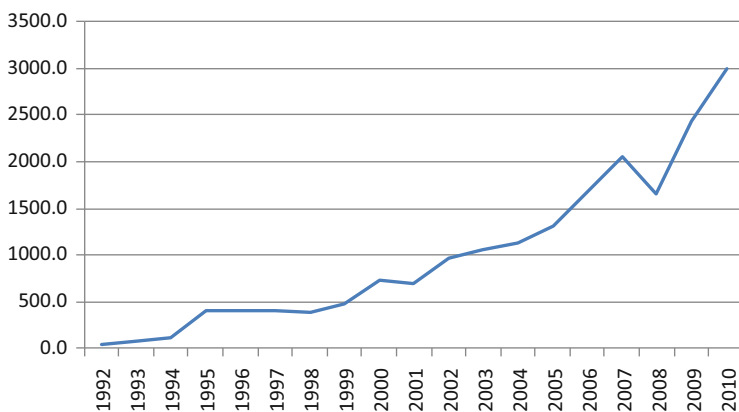
Almost all areas with the best economic or export results involve foreign capital in some form. This should serve as a compass so that further progress can be made with this type of business, even in areas that are sensitive for the population or in consumption areas.

The generation of hard currency export earnings has grown steadily by following the policy guidelines of the Party and the State regarding the promotion of Cuban





**Fig. 10.9** Sales of goods and services by IEA (in millions of pesos). *Source:* Ministry of Foreign Trade and Foreign Investment. Annual Reports. Havana



**Fig. 10.10** Exports of Goods and Services from International Economic Associations (MMP). *Source:* Ministry of Foreign Trade and Foreign Investment. Annual Reports. Havana. Important Lessons for Cuba Based on Foreign Investment in Vietnam

exports. The policy seeks to maximize export income, given the high external dependency of the Cuban economy. The economy depends on acquisition of a wide range of products in the international market, including food products, which have experienced considerable price increases (Fig. 10.10).

Compared to Vietnam, there are major differences in the evolution of foreign direct investment in Cuba, but an important similarity between the two cases is that the economic reforms implemented in Vietnam emerged from economic conditions similar to the ones currently faced by Cuba. Like Cuba, the Vietnamese transformation involved changes within socialism, starting from a very underdeveloped country that failed to solve underdevelopment problems with central planning and the

classic European socialist model; in addition the reform was led by the Communist Party.

Principal features of the Vietnamese model:

1. Agricultural reforms played an important role by targeting food self-sufficiency, which resulted in increased production and productivity.
2. Inefficient public enterprises were closed down or transformed through the creation of cooperatives, privatization, or association with foreign capital in search of international competitiveness.
3. Positive impact on economic growth was achieved after opening the economy to diverse forms of ownership.
4. Notable economic growth and increased efficiency resulted from the expansion of monetary and commercial relations, especially the role of the market based on a strategic plan.
5. Substantial openness to foreign markets was allowed, particularly for large annual foreign capital inflows and the consequent impact on exports from the investing countries.
6. There was steady improvement in the macroeconomic climate in terms of increased average annual GDP growth, sustained increase in international monetary reserves, and other indicators.
7. Constant increases in individual consumption were achieved through consumption credits, wage increases and other consumer incentives.
8. In Vietnam economic growth has been accompanied by a strong institutional reorganization.
9. Vietnam is notable for rejoining international bodies, including the World Bank, as a result of which important credits have been granted.
10. Reforms in Vietnam involved profound transformations in other areas, especially in the country's financial system.
11. The Vietnamese were able to establish a strong relationship between FDI and exports, as well as between exports and increased international monetary reserves.

Factors Attracting Foreign Capital in Vietnam

1. The country implemented both incentives and restrictions on foreign capital, but decision-making was always pragmatic.
2. Legislation covering foreign direct investment in Vietnam has been regularly modified according to the progress of established enterprises.
3. Very favorable tax incentives were created that successfully encouraged foreign investment in designated regions or sectors.
4. From a structural point of view, FDI as a source of investment in Vietnam is clearly seen as a *complement to domestic sources of funding*.
5. The duration of partnerships with foreign capital has expanded over time.
6. Currently, companies with foreign investment have direct access to domestic and foreign markets, but at an initial stage "bridge companies" facilitated linkages to other entities within the country.

7. Companies with foreign capital participation in Vietnam freely contract labor.
8. In certain periods, income tax exemption is applied to encourage particular activities, especially infrastructure projects such as port construction or activities that facilitate access to state-of-the-art technologies.
9. The Vietnamese use build-operate-transfer contracts as a means of attracting large amounts of capital, mainly for infrastructure construction.
10. Participation of Vietnamese living abroad is encouraged “as their contribution to national reconstruction.”
11. Vietnam offers extensive guarantees to foreign investors to repatriate their share of business profits, technological transfer payments or other services. Permission is granted to investors and foreign workers to buy homes while in Vietnam.
12. The foreign investment sector has come to account for 37.2 % of Vietnamese industrial output and 57.4 % of total exports.

What can Cuba learn from Vietnam’s experience of a greater role for foreign capital?

1. Cuban authorities should bear in mind that external financial resources are scarce, and are flowing to developing economies, especially to Asian economies, not only due to the advantages provided by individual countries, but also because Southeast Asia is the most dynamic area in the world today, a trend that will continue in the coming years.
2. Cuban legislation on foreign capital is very expansive and includes elements that could lead to a massive influx of foreign capital. However, the government is still not willing to use this variable on a large scale, at least in the short term, although the national project of “economic and social guidelines” reflects the need for external resources via foreign direct investment.
3. The Cuban Ministry of Foreign Trade and Foreign Investment and legislation that protects foreign investment are not enough to stimulate investment; the Vietnamese experience shows that the rest of the country’s institutions must be aligned with this objective, facilitating and rather than hindering the advance of these resources.
4. Activity such as infrastructure in which investment recovery periods are very long require tax exemption policies for a given period of time, or wholly foreign-owned companies should be permitted for a specific period.
5. It is best to limit the use of discretion in the approval of businesses, and all invitations to tender should be published.
6. Foreign capital inflow from Cubans living abroad should be encouraged, while Cuban private entrepreneurs should be allowed to partner with foreign entrepreneurs in small and medium enterprises.
7. Cuba’s integration into international financial organizations could be analyzed and implemented.

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# Chapter 11

## Non-State Socially Responsible Enterprises: The Key to Inclusive Economic Growth in Cuba

Julia Sagebien and Rafael Betancourt

### Introduction

Cuba finds itself (once again) between a rock and a hard place. The rock has two surfaces. One of the rock's surfaces is that the economic recovery dynamics it had set in motion to counteract the calamities of the special period, are too slow and uneven to significantly boost economic growth. The other surface of the rock is that the recovery in citizen's quality life that accompanied this economic recovery has been unequally distributed in terms of age, race, gender, and geography. For many Cubans, social mobility has meant a slide downward or a never-ending struggle to remain in the same place.<sup>1</sup> The hard place is that in order to reignite the momentum of economic growth, the "updated" economic guidelines known as the *Lineamientos*<sup>2</sup> have introduced market dynamics into the local economy that despite being modest will steadily alter the power relations.<sup>3</sup> On the one hand, they will exacerbate the existing inequalities between citizens. On the other, they will alter existing balance between the state and its citizens as a result of the contemplated massive state sector layoffs (over one million workers) and of the emergence of citizen entrepreneurs who do not depend on the state for their livelihood (the goal is 45 % non-state

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<sup>1</sup> See Domínguez et al. (2012).

<sup>2</sup> See Partido Comunista de Cuba (2011) on the "*Lineamientos de la Política Económica y Social del Partido y la Revolución*" or "Resolution on the Guidelines of the Economic and Social Policy of the Party and the Revolution."

<sup>3</sup> See Domínguez et al. (2012), Peters (2012a, b), and various in Ritter (n.d.) The Cuban Economy Web page.

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employment by 2016). Since, unfortunately, there is no thriving large private sector ready to absorb these displaced workers, the net effect of these layoffs could be an increase in the ranks of the unemployed, the underemployed and the poor—this would mean, in turn, an increase in an underprivileged, unhappy, disillusioned, frustrated and volatile civil society.

The search for practical and theoretical lessons that can make a contribution towards a revised Cuban development model has led Cuban scholars and policy makers to examine a number of comparative experiences. The market transition experiences of countries such as China and Vietnam have been especially useful in exploring how market forces can be introduced into socialist/communist economies in order to spur economic growth, while at the same time managing (or not) the resulting social disparities and the threats to political cohesion characteristic of these transitions. The slowness of the updating process so far, suggests that Cuban leaders show a preference for the Vietnamese model of gradual introduction of market forces. However, whether this timidity is due to conscious design, to the lack of a clear model and a way forward or to “bureaucratic insurgency” (Domínguez 2012), is not clear at this time. Whatever the reason, the political challenges to updating the model will be as daunting as the social and economic ones.

The *Social and Solidarity Economy* (SSE) movements of socialist-leaning ALBA (Bolivarian Alliance for the Peoples of our America) countries have also provided a particular useful reference point for Cuba’s quest to find a development model that blends socialist values with market dynamics. Though these countries are moving towards socialism rather than away from it, the shared cultural, ideological, and historical heritage of Cuba and the other ALBA countries would make these lessons somewhat easier to apply than those of more distant Asian countries.

This paper argues that in order to facilitate domestic market liberalization within a socialist framework, besides the comparative experience mentioned above, two additional sets of experiences merit careful consideration. One is the experience of more politically neutral and of more broadly conceived *Social and Solidarity Economies* (SSE) and of the many kinds of *Socially Responsible Enterprises* (SRE) that comprise them. The other is the lessons that can be learned from *Inclusive Market Development* (IMD) models, a development policy framework that fosters sustainable development through productive activity.

The adoption of aspects of these two suggested sets of experiences would provide Cuba with a number of much needed benefits: (1) IMD policies and programs provide ways to harness market forces quickly and could spur the rapid growth of the *Empresas no Estatales* (ENE) or *Non-State Enterprise* (NSE) sector being fomented by the new economic policies of the Cuban state; (2) research on SSEs highlights policy frameworks specifically designed to create the necessary conditions for addressing social/environmental externalities through successful enterprises; (3) the intersection of IMD and SSE policies maps out ways to link economic sectors into business networks (e.g., value chains) in ways that deliver *triple bottom line* (economic, social, and/or environmental objectives) results; (4) the adoption of SSE, SRE, and IMD business system models could bring much needed international

support in the form of financial resources, know-how, and market access, even while the US Embargo is still in place; (5) social enterprises can become self-supporting through their business earnings, thus relieving the coffers of the state in areas of both enterprise promotion and social service provision; (6) at a national accounts level, alternative economic indicators such as Genuine Progress Index (GPI) and Bhutan's Gross National Happiness (GNH) suggest that socially responsible enterprises and strategies have positive economy-wide social and environmental spill-over benefits; (7) from a business efficiency point of view, the greatest value of these suggested models for Cuba is that the outstanding variety of socially responsible enterprises and business system examples on which to draw from suggests that it is not necessary to over rely on cooperative ownership structures in order to maintain socialist and solidarity values.

Whatever the model of development is to be, and whatever it does borrow from other experiences, the model will have to answer the question: *How can market forces be harnessed in a manner that (1) creates economic growth, (2) controls the disparities that accompany these transition processes, (3) maintains sufficient political cohesion for swift implementation, and (4) establishes a new model of market socialism based predominately on self-managed economic units interacting within a planned economy?* The unique element that the social entrepreneurs, government planners and citizens involved in SSEs/SREs/IMD can contribute to the debate over Cuba's economic model is the way in which they reframe this question in a manner that suggests that zero sum tradeoffs (market forces vs. social equity) and trickle down time lags can be avoided. Their reframed question, instead, is this—*How can market mechanisms themselves be used to achieve both social and environmental objectives along with economic objectives, at the same time?*<sup>4</sup> Since the Cuban model of development will be, like all things Cuban, *sui generis* and reflect Cuba's unique realities, it is essential to locate this last question in a Cuba-specific context suggesting the formulation: *Can Non-State Enterprises become Socially Responsible Enterprises and in that way build a new type of Social and Solidarity Economy in Cuba?* This paper addresses this latter Cuba-specific question.

In order to address the question, we undertook a broad literature review and a number of fieldwork activities. Our review of the literature focused on three topics: (1) the economic, social and political challenges faced by the *Lineamientos*; (2) the recent experience of SSEs in capitalist countries (South Africa, Canada, Brazil and Spain) and in socialist-leaning ALBA countries (Bolivia, Ecuador and Venezuela); and (3) the global literature on SREs and IMD strategies. A summary of the extensive fieldwork in Cuba, Ecuador, Canada and Brazil involved in drafting this work can be found in a document entitled "Socially Responsible Enterprise, Local Development in Cuba" (SRELD) available in The Cuban Economy blog.<sup>5</sup>

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<sup>4</sup>This question was explored at some length during the domestic market liberalization of the 1990s. Unfortunately, these policies were drastically reversed in subsequent years. See UNESCO et al. (1998).

<sup>5</sup>Ritter (2013, January 14).

The careful examination of the application of SSE, SRE and IMD models in an integrated manner is of utmost relevance to Cuba if only for one reason—parts of these models are already being applied in an ad hoc manner. For example, the many incentives being given to cooperatives suggest that the Cuban economy will naturally transform itself into a non-state-cooperative-based SSE. However, there are many other types of SREs that could readily be adapted to Cuban needs and preferences. Classic IMD policies are also being applied in Cuba. For example, the efforts to create inclusive value chains, encourage entrepreneurship, provide microcredit, and focus on local development are classic IMD. Enhancing the likelihood of the success of these endeavors by understanding them and learning from their application in a variety of settings is imperative. This paper offers a guide for the exploration of these two comparative sets of experiences and offers some initial reflections on how these models might be applied holistically in the development of an updated Cuban economic model.

Section “Part 1” of the paper is the introduction presented above. Section “Social and Solidarity Economies, Socially Responsible Enterprises and Inclusive Market Development” defines and clarifies key terms. Section “What Is the Size and Impact of SSEs and SREs?” reviews the size and impact of social and solidarity economies in selected countries. Section “Contextualizing the Discourses of SSEs, SREs and IMDs Within a Left–Right Political Spectrum” places these enterprise and development models in a left–right ideological and political context. Section “SSE/SRE/IMD and the NSE Sector: Compare and Contrast” compares and contrast these models with Cuba’s emerging non-state enterprise sector and the policy context that surrounds it. Section “How Can Non-State Enterprises Become Socially Responsible Enterprises and in that way Champion Social and Solidarity Economy in Cuba?” discusses how a non-state-enterprise-based social and solidarity economic systems could be built in Cuba. Lastly, Section “Conclusion: (IMD Enabled) NSE+ (Policy Facilitated) SREs (Could Indeed)=SSEs (But only if the NSE Sector Is Allowed to Grow Much Faster Than It Is)” presents a brief set of conclusions.

## **Social and Solidarity Economies, Socially Responsible Enterprises and Inclusive Market Development**

Clearly defining what a social and solidarity economy is, establishing parameters through which to determine exactly what kinds of socially responsible enterprises merit inclusion in that category, as well as the development and enterprise promotion policies that enable these business systems, is a daunting task beyond the reach of this work. This section of the paper aims to clarify these terms by providing brief definitions of SSE, SRE, and of IMD, describing how these forms of enterprise are related to each other, and the agency dynamics of their development model. It also suggests electronic portals for further information gathering.



## Definitions

*Social and Solidarity Economies* are comprised of “enterprises and organizations that produce goods, services and knowledge while pursuing economic and social aims and fostering solidarity” (ILO, *ibid* p. vi). Traditionally, SSE enterprises have taken the form of cooperatives, mutual benefit societies, associations, and foundations. SSEs can be understood, fundamentally, as macro level economic systems composed of solidarity organizations involved in business activities as a way to reach social and/or environmental goals. There is a great deal of debate regarding exactly what kinds of enterprises merit inclusion in an SSE resulting in a “narrow”, as well as a “broad” definition of what comprises them. According to [Neamtam \(n.d.\)](#), the “narrow” definition of the social economy includes five main features: (1) legal structure is nonprofit mutual and cooperative enterprises; (2) have certain rules about who controls use of capital; (3) independence from government; (4) democratic form of control; and (5) based on principles of collective and individual empowerment. A “broad” definition of SSEs would include a range of other enterprise forms including those which are non-collectively owned and managed and those with for profit purposes. This broader definition is explored subsequently.

The International Labour Organization’s (ILO) Social and Solidarity Economy Academy (ILO 2011) and the International Center for Reference and Networking for Public Policies for the Social and Solidarity Economy (RELIESS)<sup>6</sup> and the Chantier de l’économie sociale are provide useful portals to information about SSEs.

*Socially Responsible Enterprise (SRE)* is a more firm-level microeconomic term that refers to enterprises, as well as enterprise systems (e.g., value chains) that share one characteristic—they have social and/or environmental objectives, as well as financial objectives. SREs can be understood, fundamentally, as individual business organizations that pursue social and environmental goals, with or without solidarity management or ownership goals. Two terms that are often associated with the term SREs are “social entrepreneurship” or “social venture”.

The term SRE encompasses a very “broad” set of enterprises with a triple bottom line orientation. These include: (1) fair trade systems; (2) social ventures/social entrepreneurship; (3) social venture financial/capital markets; (4) not for profits; (5) religious organizations; (6) mutual aid systems arising out of community groups; and (7) social enterprises. Socially responsible enterprises come in all financial and employee sizes, ownership forms, geographic locations, market reach, market dominance, complexity, financing mechanism, are in all sorts of industries, and provide both products and services.

Portals to the wealth of SRE information include: The Social Venture Network, the Global Impact Investment Network, Microcredit Summit, Fair Trade

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<sup>6</sup> See [RELIESS \(n.d.\)](#). Of special relevance are the cases prepared for the FIESS Conference (2012) on the themes of: Territory and Local Development; Innovation and Collective Entrepreneurship; Solidarity Finance and Trade; Work and Employment; Food Security and Sovereignty.

International, B Corps, Instituto ETHOS, The Skoll Foundation, Ashoka and AVINA Foundation.

*Inclusive Markets Development* (IMD) is an approach to development that focuses on “inclusive markets”, meaning “markets that extend choices and opportunities to the poor (and other excluded groups) as producers, consumers and wage earners.... The IMD approach focuses on entire markets or sub-sectors that are important to the poor by addressing barriers to inclusive market development at various levels (micro, meso and macro). Such barriers may range from lack of appropriate policies, over limited access to finance and markets, missing business and value chain linkages, capacity constraints to lack of infrastructure, etc.”<sup>7</sup> IMD policies include policy and institutional infrastructure, value chain integration, provision of affordable goods and services, entrepreneurship development and pro-poor corporate social responsibility (*CSR*).

Useful portals to IMD policies are provided by the UNDP, and the “Markets for the Poor” or M4P sites, an alternative term for IMD.

### ***Enterprise Forms and Their Relationships to Each Other***

All enterprises included in either a narrowly or a broadly defined SSE, are SRE enterprises. However, not all SRE enterprises necessarily qualify for inclusion in an SSE (e.g., are top of the line “green” products for the very rich solidarity enterprises?). As examined earlier, narrowly defined SSE have very strict requirements for inclusion. In more broadly conceived SSEs, however, often the solidarity ownership and solidarity governance requirements, as well as the requirement that the enterprise be organized as a not for profit of the narrowly conceived SSEs, are waived and replaced by the looser requirement that the enterprise have genuine social and/or environmental objectives. A triple bottom line is the *sine qua non* for inclusion of an enterprise in a broadly defined SSE. In this paper, we will adopt the “broad” definition of SSE and we will use the compound term *SSEs/SREs*.<sup>8</sup> This compound term takes advantage of the vagueness and relative fungibility of the terms.

Inclusive Market Development is the broadest category. This development approach encompasses both traditional for profit enterprises, socially responsible enterprises of all kinds, and all sectors in society. IMDs could be said to encompass SSEs/SREs.

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<sup>7</sup> See [UNDP \(n.d.\)](#).

<sup>8</sup> Granted, this will cause concern for those who adopt only narrow definitions of SSEs.

## *Role of Agents of Development*

In capitalist countries, SSEs/SREs are created primarily through civil society organizations. They remain, nevertheless, very much dependent on strategic relationships with the state and with the private sectors. SSE/SREs often arise as citizen's response to economic, social or political crisis. For example, in the post neo-liberal reform world of Latin America, SSE and SREs enterprises have arisen as a response to a combination of: (1) the failure of the market to achieve inclusive growth and sustainable development and (2) the "governance gaps" left by the diminished capacities of retrenched state.

Citizens as social entrepreneurs have become the new heroes of the SRE movement, especially in the USA. Thus, SRE literature tends to mirror business literature with its focus on the components of firm success more than it does the development literature with its focus on the development of enabling policy environments.<sup>9</sup> Citizen involvement in SSE/SRE has also taken the form of changing consumption patterns such as the trend towards green and socially conscious consumption and certification schemes.

The IMD approach is not civil society-centered. IMD promotes the targeted participation of *all* relevant social actors at various levels and in all economic sectors. This process involves a broad range of actors including supranational institutions, development agencies, local governments, community leaders, academia, private sector, and civil society organizations. IMD attempts to make these development stakeholders work together to create better terms for the poor as they engage economic systems. For example, IMD policies include business strategies such "*Pro-poor corporate social responsibility strategies*" designed to improve the livelihoods of targeted stakeholders communities through market activities such as bottom of the pyramid strategies, pro-poor tourism, inclusive value-chains (e.g., preferential buying).<sup>10</sup> These Pro-poor CSR strategies are often complemented by targeted pro-poor government procurement. While the corporate entities and states that engage in pro-poor programs cannot be considered SRE enterprises *de facto*, their pro-poor programs and strategies can be considered part of broadly defined SSE enterprise systems.

IMD is a policy framework that places emphasis of the *web of economic relationships* that all of the aforementioned entities create as they interact with each other, with the local, national and international economy at large, with government agencies, civil society organization and with their social stakeholders, with the private sector, and with its CSR strategies. Together, all these entities and interactions they form the corpus of the interrelated IMD development framework.

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<sup>9</sup>Montgomery et al. (2012) have introduced "collective social entrepreneurship" and the need to research not just individuals but also the collaborative networks in which these social entrepreneurs function.

<sup>10</sup>See Sagebien and Whellams (2011) for a review of the relationship between CSR and development.

As will be examined in a subsequent section of this paper, there are several time-proven and successful IMD-oriented programs taking place in Cuba.

## **What Is the Size and Impact of SSEs and SREs?**

According to Sousa and Hamdon (2010), the key challenge in answering this question for the SSE sector is the lack of a standard approach to defining, isolating, organizing and accounting for the information. Estimating the size of the SRE sector is equally difficult for reasons that parallel those in the SSE sector. Thus aggregate information that recognizes the breadth of the Social Economy across sectors and jurisdictions is very rare. In the developing world, the difficulty of estimating the size and impact of the SSR/SRE sector is further exacerbated by two factors: (1) the inadequacy of the statistical gathering infrastructure; and (2) the immensity of the informal sector which is considered to be part of the “popular and solidarity” sector and thus part of the SSEs.

In jurisdictions where SSEs/SREs have been articulated into the mainstream economy and supported by state policy at different levels, good estimates of the size and impact of this sector are generally available. For example: (1) the Brazilian SSE includes 22,000 enterprises that involve 1.6 million members and offer 500,000 jobs (Gaiger and Dos Anjos 2011); (2) the EU SSE represents 2 million enterprises (i.e. 10 % of all European businesses) and employs over 11 million paid employees (the equivalent of 6 % of the working population of the EU) (European Commission, n.d.); (3) Canada’s combined nonprofit and voluntary sector is the second largest in the world when expressed as a share of the economically active population, with a 2003 estimate of 161,000 organizations employing two million people, or 11.1 % of the economically active population (Imagine 2010).

Despite these noteworthy economic contributions, to date, SSE/SREs remain fundamentally small complimentary, enterprise-based socio/economic systems operating within mainstream economies populated by mainstream businesses. Nevertheless, though still modest in sector size, they are of great value to states, firms and citizens because inclusive, participatory and solidarity cultures foment social, political and economic stability, especially during economic downturns. Not surprisingly, the SSE/SRE sector is growing worldwide.

## **Contextualizing the Discourses of SSEs, SREs and IMDs Within a Left–Right Political Spectrum**

Economic conditions in Cuba might be dire for internal and external reasons, but economic updating is not a departure from socialism. The operating space being given to Non-State Enterprises is a change in means, not ends. Therefore, the

“political correctness” of SSE, SREs and IMD discourses is very relevant in a Cuban context. This section contextualizes the discourses of SSE, SREs and IMD within a left–right political spectrum.

## *SSEs and SREs*

### **Socialist Countries and Cuba**

In orthodox socialist/communist countries, SSEs can be said to exist and, in fact, can be said to be, the overall purpose of economic activity. Unlike SSEs in capitalist countries, socialist/communist SSEs are created through state sector controlled economic/social and political systems, planned economies and state-owned enterprises. These enterprises have implicit solidarity objectives (the egalitarian nature of the socialist system itself) and rarely have explicit social and environmental objectives.<sup>11</sup>

Cuba is currently exploring alternative ways to develop a non-state sector-based, socialist-oriented SSE through “self-managed social organizations” (“*organizaciones sociales autogestionarias*”). The essays contained in Piñeiro Harnecker (2011) argue that cooperatives are the ideal form of self-managed social organization enterprise for Cuba’s updated economic model because cooperative models: (1) are congruent with the theoretical framework and values of socialism (e.g., solidarity property ownership, collective well-being over narrow individual profit preoccupations, and pernicious employer–employee dynamics); (2) are able to contribute and correspond to the directives of both a centrally planned economy and to the exigencies of local development initiatives; (3) are socially responsible; and (4) enshrine solidarity and democratic management approaches which provide built in-measures to counteract corruption, though close state supervision is, nevertheless, required.

It is quite certain that cooperatives can be good for Cuba. What is less certain is, if Cuba can be good for cooperatives and for other kinds of SSEs/SREs. SSEs/SREs emerge more readily “out of democratic public cultures—democracy seen not just as elections but as a democratic public life—that pressure and complement the individual motivations” (Daubón 2012, personal communication). This is true even in left of center contexts. For example, Vieta et al. (2011) study of Venezuela’s “Socialist Production Units” and Argentina’s “Worker-Recuperated Enterprises” argues that in contrast to traditional cooperativism in the region, this new movement displays stronger horizontal organization and democratic values, and has deeper connections to surrounding communities. Whether a command/control, top-down, planned economy such as Cuba’s is capable of developing the consultative and inclusive political management styles that can foster solidarity economies, remains to be tested in practice.

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<sup>11</sup>This lack of explicit environmental objectives and the assumption that social objectives were being met de facto through state ownership and control might be one of the contributing factors to the appalling environmental record of Soviet-era industries in COMECON countries.

The Cuban political/managerial culture will also have to change from that of “doers” to that of “facilitators”. Since SSEs/SREs arise more readily in a bottom-up fashion the Cuban state will have to learn how to leave space for the independent and autonomous action of the NSEs sector. This space for action will need to be both respected (in order to promote efficiency) and enabled through policy incentives (in order to compensate for the additional complexities of managing triple bottom line enterprises). The conversion of citizens and bureaucrats into entrepreneurs and then into social entrepreneurs will require a shift in the “agency” of the economy. Accomplishing this his cultural shift successfully might be the one of the biggest challenges ahead. Fortunately, the new dimension that the local community sphere has been progressively gaining as a component of local economic development policy frameworks fostered by the CEDEL and others, has set the stage for state decentralization, greater community participation, visibility, and inter-sectorial knowledge sharing.<sup>12</sup>

Perhaps the greatest conceptual barrier to the application of SSE/SRE and IMD models is the way in which “civil society” is conceptualized by the promoters of these models, as well as the role that is given to civil society members as the key economic and political actor of SSE/SRE economic activity. This emerging democratic, participatory civil society sector is likely to concern Cuban bureaucrats for reasons articulated by Betancourt (2012). Betancourt states that an analysis of civil society in Cuba faces two complex issues, one theoretical and the other political. Theoretically:

The notion of civil society most accepted in the West [in the discourses of the left and the right alike] considers it distinct from and often in opposition to the State, in practice restricted to non-governmental organizations (NGOs). It encompasses the realm of voluntary and spontaneous associations of individuals and is viewed as a homogeneous, positive space...Conversely, most Cuban scholars would argue that civil society and State are inter-related: some government institutions form part of civil society while some civil society structures form part of the State (Betancourt (2012), p. 3)

Politically, proponents of civil society in Cuba face a double challenge. On the one hand, there is an inherent conflict between a political system that has an all-embracing, paternalistic conception of the State and that vertically controls all political and economic life, and a civil society that sees itself as independent from such a State and sees its actions as legitimate political acts. On the other, beginning in the 1990s, the US government, the counterrevolutionary exile groups and the so-called dissident groups within Cuba raised the banner of promoting civil society in Cuba as a means of overthrowing the established government.<sup>13</sup>

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<sup>12</sup> See Guzón Camporredondo (2006).

<sup>13</sup> The Cuban Democracy, or Torricelli Act of 1992 and the Helms-Burton Act of 1996 provided for the hardening of the US embargo of Cuba and made explicit the aim to subvert the Cuban government from within, by funding “independent” or antigovernment NGOs. Between 2004 and 2009 the US government is estimated to have spent more than \$137 million to fund “the democratic opposition” and the “emerging civil society” in Cuba.

In sum, the fact that civil society can be considered an illegitimate political actor, and its actions and motives can be suspected of counter-revolutionary motives makes the articulation of civil society actors into Cuba's updated model of development a very difficult and thorny proposition.

## Latin America

In the region, the term Social and Solidarity Economy is associated and often conflated with "*Economía Popular/Economía Solidaria*" movements, though these two don't necessarily stand for the same socioeconomic phenomena, the main difference being that the definition of the Latin American popular economy includes the economic activity of the often very large informal sector.

In ALBA countries such as Venezuela, Bolivia and Ecuador SSEs have been enshrined in their economic development plans and in some cases, in their constitutions. The Venezuelan model is cooperative-centric.<sup>14</sup> According to Delgado Bello (2012), the Venezuelan government fostered the cooperative movement through state development policy, a supportive legal framework, preferential procurement and ample financial support. From 2001 to 2011, the number of legal cooperatives went from 1,000 to 340,000. However, it has not all been roses. In 2008, a survey of the legalized cooperatives showed that only 23 % of those registered still remained operational. This prompted some observers to remark that Venezuela was a "Cemetery of Cooperatives" (Delgado Bello 2012). The analysis of this failure suggests that improperly supervised cooperative promotion frameworks can create conditions for opportunism. It also revealed that cooperatives that arose "spontaneously", innovatively, out the existing solidarity tradition and that leveraged their relationships to the private and public sector, had a better chance of success. Authentic self-organization appears to be essential.<sup>15</sup>

Ecuador<sup>16</sup> and Bolivia<sup>17</sup> have adopted more broadly defined SSEs, centered the notions of on "Buen Vivir" or "living well". The post neoliberal development paradigms of Ecuador's "Sumak Kawsay" (in Kichwa) and Bolivia's "Sumaj Qamaña" (in Aymara) reflect both an awareness of the inextricability of their economies from the market-driven globalized world of the twenty-first century, as well as a commitment to social rights, to collective citizenship, to environmental sustainability, and to the need to move away from extreme consumerism.

Brazil has one of the most active, powerful, well-studied, and most deeply and broadly defined SSEs sectors in Latin America.<sup>18</sup> Despite the many debates taking place, a lesson that stands out from the Brazilian experience is the importance of the co-construction of the sector by civil society and the public agencies and private

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<sup>14</sup> See Cooperativa Gestión Participativa (n.d.) for information on Venezuela's cooperative sector.

<sup>15</sup> See Azzellini (2011).

<sup>16</sup> See Radcliffe (2011) and Placencia (2012).

<sup>17</sup> See Gaceta Oficial de Bolivia (2010).

<sup>18</sup> See Gaiger and Dos Anjos (2011) and Dubeux et al. (2011).



sector, despite the different orientations of each, and the often difficult relationships between the various solidarity forums, public policy organs and corporate actors. Unfortunately, despite its vibrancy, the sector is still fragile and marginal, and has had limited impact despite its growth. Fortunately, addressing its weaknesses remains a priority for its co-builders.

The more individual-centered notion of *social entrepreneurship* is more recent in Latin America and it tends to reflect its Northern business-oriented roots. For example, Harvard University-sponsored Social Enterprise Knowledge Network was an early mover in the SRE/social entrepreneurship space in the region.

## **EU, USA, and Canada**

In developed capitalist countries, the discourse of SSEs has been associated with “solidarity traditions” (e.g., Basque country, Emilia-Romagna in Italy, the Nordic countries, Quebec in Canada) and “fair work traditions” (e.g., International Labour Organization), as well as with cooperative movements (e.g., Mondragón). In Europe and Canada it is often associated with the term the “Third Sector” which has a broad SSE connotation.

In the USA, the macro-oriented language of SSEs as a systemic alternative economic model is rarely used. Instead, discourse and research tend to center around the more microeconomic-oriented phenomenon of SREs and their business pursuits. For example, in the USA there is an intellectual ferment around topics such as social entrepreneurship/social venture; corporate social responsibility social venture and Impact investment and socially responsible investment (SRI), especially in business schools.<sup>19</sup>

## ***Inclusive Market Development***

The notion of harnessing market forces as a means through which to reduce poverty gained momentum in development circles with the release of the UN’s Commission on the Private Sector & Development document entitled *Unleashing Entrepreneurship: Making Business Work for the Poor* (UNDP 2004). This document reflected a trend in development theory away from neo-liberalism and the Washington Consensus. In Latin America, this trend in development policy, championed by ECLAC, came to be known as *neo-structuralism*. Like neo-liberalism, neo-structuralism is firmly grounded in the importance of markets, especially export markets, in achieving economic growth. Neo-structuralism, however, is less mechanistic in its understanding of the invisible hand and doesn’t assume that market forces operate in level playing fields. Thus its analysis includes the effects of social and political structures as well as institutional, cultural and psychological factors, and its policies advocate a

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<sup>19</sup> See The Aspen Institute’s Business and Society Program (n.d.).



development model with a far greater role for the state and for civil society with targeted strategies to achieve more inclusive and equitable growth, many of these in concert with the private sector.

IMD policies in Latin America are evident in the early adoption (e.g., microfinancier FINCA started operations in 1984) and the rapid expansion of the microfinance sector. IMD frameworks have also been used worldwide—in developing countries, in countries moving towards market-based systems such as those of the former socialist bloc, as well those incorporating more social and solidarity values into their economy such as the ALBA countries. For example, a partnership between the government of Bolivia and the World Bank has a clear IMD-oriented understanding of development (World 2011) that fits within the “Sumaj Qamaña” development model. Moreover, this new flexibility in development models and willingness to engage a pluralist ideological world includes not just the World Bank, but also, according to Feinberg (2011) the IMF. The stage for the step-by-step rapprochement between the international financial institutions (IFIs) and Cuba suggested by Feinberg (2011) appears to be set. It is not clear, however, who will blink first.

The terms “Inclusive Market Development” and “Markets for the Poor” (M4P) with their use of words such as “markets” and “poor”, clearly signal that they are anchored in a world-view of market-based economies, inequalities and marginalization of the poor. Moreover, the notion of “inclusive” implies extending the benefits of capitalism to the “poor” by further linking the economy of the rich with the economy of the poor in an effort to not only alleviate poverty, but to foster the growth of the middle classes through SMEs. M4P uses the term “missing middle” refers to the lack of a thriving small and medium enterprises (SME) sector in developing countries and to the consequences this has on development. “Developing countries have a large number of microenterprises and some large firms, but far fewer small and medium enterprises. In high-income countries, SMEs are responsible for over 50 % of GDP and over 60 % of employment, but in low-income countries they are less than half of that: 30 % of employment and 17 % of GDP.”<sup>20</sup> The conflation of the growth of the missing middle with the return of the bourgeoisie will create concern in Cuba.

Though IMD and M4P development frameworks have worked well in socialist-leaning economies and have managed to foster many solidarity-based enterprises, the fact that they do not promote a path towards socialism will likely cause great discomfort in Cuba. Politically correct alternative terms and logics will have to be developed for the Cuban policy wonk audience. A contender might be “Asset Based Citizen Led Development” (Mathie and Punttenney 2009). This approach helps communities to mobilize and build on their own local, cultural, financial, community, and personal skills, etc., assets towards sustainable development. It is very much in line with Cuba’s Local Economic Development policies promoted by the CEDEL. Part V of this paper outlines a number of thriving IMD/M4P inspired projects already taking place in Cuba.

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<sup>20</sup>Center for International Development (n.d.).

## **SSE/SRE/IMD and the NSE Sector: Compare and Contrast**

Part 2 of the paper provided basic definitions of SSE/SREs and IMD concepts; Part 3 quantified SSEs/SREs; and Part 4 located these concepts within a left–right political spectrum. Part 5, can now compare and contrast these with Cuba’s NSE sector.

Perhaps the most salient point of convergence between SSE/SRE/IMD and the updated Cuban economic model is the centrality of concern over the socio-economic welfare of citizens. All overtly target the amelioration of the living standards of disadvantaged and marginalized groups (e.g., gender, race, socioeconomic strata, and geographic regions) by seeking new market solutions to old problems. They are both born out of crisis—the failure of mainstream economic systems, capitalist and socialist alike, to deliver sufficient growth and sufficient inclusiveness at the same time. For both, formalizing the informal economy is key in achieving both inclusiveness and sustained economic growth. Though taxes and red tape will remain the vain of such newly formalized enterprises, the advantages for them are numerous—legal protection, access to less usurious capital, and the ability to build equity. For both, entrepreneurial spirit is the life force of business start-ups and long-term success. The development of an enabling public policy environment is a key concern in both cases.

Though the SSE, SRE, and IMD models and the Cuban NSE sector share a number of characteristics, the policy environment, the domestic demand conditions, and the external sector terms of trade they face are quite different (see Table 11.1).

Some of the differences in conditions outlined above, such as the scarcity of inputs daunting as they are, can perhaps be overcome comparatively easily. Those differences rooted in over 50 years of political thinking or in uncertainty about how their implementation might alter the power relations between the state’s bureaucratic apparatus and Cuba’s up-and-coming class of citizen/entrepreneurs and their funders—will be more difficult to overcome. The lack of freedom to operate and act independently from the state combined with the state’s distrust of capital accumulation in private hands and of the growth of the “missing middle” for ideological and/or power relations reasons alike—will continue to hamper the rise of a thriving entrepreneurial based economy, as well as the SRE-based SSE sector.

## **How Can Non-state Enterprises Become Socially Responsible Enterprises and in That Way Champion Social and Solidarity Economy in Cuba?**

Now that we have established what SSEs/SREs and IMDs and NSEs are, how they relate to each other conceptually, politically and in practice, Part 6 suggests some basic steps that can be taken to bring these together in a Cuban context.

**Table 11.1** Major differences in orientation between SSE, SRE, and IMD models in capitalist countries and Cuba's NSE sector

Component	SSE, SRE, IMDs in capitalist countries	Cuba's NSE sector
Market system	Capitalist base	Socialist base
Private property rights	Cornerstone of capitalism and purposefully fostered	Distrust of return of individual property (i.e. NSE does not equal private). Cooperatives favored over private firms. State-run enterprises will continue being main form of property
Primary economic actor	Civil society organizes and partners with state, private sectors, development NGOs, aid agencies and the remittances of nationals' abroad	State is trying to create NSE sector through cooperatives, small farming, usufruct, self-employment, etc. It distrusts independent development NGOs and class implications of remittances from Cubans abroad Greater autonomy for state-run enterprises, while also recognizing and promoting, foreign investments
Primary organizing impetus for economic activity	Organizes around market demand and consumer needs	Prevalence of planning while taking market into account
Governance gaps <sup>a</sup>	Allow for civil society and private sector to address the gaps in the states capacity to respond to externalities	The state must grant more action space to civil society and emerging NSEs and to foreign private and NGO sectors
Managerial styles	Enshrines participatory/democratic forms of enterprise governance/Bottom Up	Process of decentralization and greater enterprise autonomy clashing with centralized bureaucratic silos and top-down command control structures
Financial intermediation services	Many types of organizations, mechanisms, and financial services serving all sizes and stages of business cycle. Use of peer lending in lieu of collateral. Very sophisticated remittance leveraging systems. IFI's very active in sovereign credit issues and development credit/investment	Mostly only state banks providing credit microfinance. Collateral requirements are high. Restriction in holding CUC accounts. The use of remittances is not well organized or leveraged. Cuba is not a member of the IFIs so no sovereign credit or major development credit/investment sources. US Embargo targets third country financial services providers
Inputs	IMD focuses on improving access to markets, finance, and information, labor, and wholesale goods/services. In many developing countries, low literacy/education levels thwart learning capacity	First world literacy/educational levels but other enterprise success inputs are inadequate

(continued)

**Table 11.1** (continued)

Component	SSE, SRE, IMDs in capitalist countries	Cuba's NSE sector
Relationship to local and international markets	Focus on gaining access to good local markets, increasing competitiveness and exports	Local market is deformed by dual currency, low liquidity, limited buying power, and excessive restrictions on enterprises. External market is state controlled
Enterprise forms	Great variety in all sectors of the economy. SME growth supported	<i>Cuentapropistas</i> allowed in only some categories. No comfort level with SMEs. The state favors cooperatives
Attitude towards capital accumulation	Fostered as a way to create "the missing middle"	Capital accumulation and the growth of the missing middle are distrusted. Concentration of property and wealth in private hands is discouraged

<sup>a</sup>"Governance gaps" refers to the inability or the unwillingness of the state sector to address the externalities of globalization effectively

### ***STEP 1 [FORWARD]: Foster the Formation of NSEs by Applying IMD Principles***

Cuba will need to have a viable and profitable enterprise sector out of which to forge a social enterprise and solidarity sector. Since IMD frameworks have been very successful in enabling the growth of enterprises of all sizes in a variety of political/economic and development stage settings, the first step is to apply IMD policies and efforts to growing Cuba's NSE sector. Below are some suggestions on how to do this.

#### **Continue to Support Decentralization Efforts in Economic Decision Management**

Since 2007, the Center for Local and Community Development (CEDEL) of the Ministry of Science, Technology and the Environment (CITMA), has been working as capacity builder and consultant to municipal governments in helping them develop their own local development strategies, based on the participation of the various local actors in planning and implementation. Municipalities with successful Local Development strategies have proven better able to access development funds from the national government as well as international cooperation, and launch successful IMD projects. CEDEL has received support from Canadian and Swiss cooperation agencies, among others.

## Scale Up and Replicate Existing IMD/M4P<sup>21</sup> Development Projects

The Cuban Association of Animal Production (ACPA) and CARE strengthened the milk production chain in Cuba through the creation of networks. These networks addressed the needs of many of the important actors of the dairy value chains such as the dairy industry, and makes links between farmers and industry by implementing an integrated value chain management model (CARE Canada n.d.). Systemic value chain value-chain approaches are a promising innovation in Cuba's development technology.

The UNDP's Program for Local Human Development (PDHL) entered partnerships with the central and local governments in an effort to promote: (1) integration of vulnerable groups into the dynamics of local and economic development; (2) support for initiatives integrating social, economic and environmental components; (3) gender empowerment in local programming; (4) local human development plans linked to the community's territorial Planning; (5) co-ordination of different international initiatives to achieve expected impact in the areas of interest to PDHL<sup>22</sup> When the program ended in 2012, local governments converted the PDHL management structures and transferred their offices and equipment to newly created provincial and municipal project offices that promote and oversee the entire range of local development projects and resources in their respective territories.

Recently, UNIDO has joined forces with UNDP is fostering the creation of large-scale integrated sustainable value chains. There a number of integrated supply chain formation pilot projects under way. For example, the PDHL is currently developing an integrated shrimp supply chain that includes the participation of NSE players. Some of this output would be exported and/or directed to CUC consumption sector (e.g., hotels). Projects related to the cocoa sector in Baracoa and fisheries cooperatives in several coast towns are also under way. *Industrial symbiosis*<sup>23</sup> modalities are also being explored as a way to use waste products for energy and recycling.

## Create Linkages to CUC Sectors and High Demand Peso Sector

Value chain and market linkages between NSE and sectors with purchase power must be fostered quickly. For example, links to the state enterprise sector, to the domestic Cuban convertible currency (CUC) sector, to the export sector, or even to large urban center Cuban peso sectors where there is adequate demand. Specially

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<sup>21</sup> Other international NGOs are also active in this IMD sector are ECODES from Spain, COSPE from Italy, Oxfam and EDF.

<sup>22</sup> See UNDP (n.d.b).

<sup>23</sup> A method for sharing of services, utility, and by-product resources among diverse industrial actors in order to add value, reduce costs and improve the environment.

designed support systems and intermediaries are needed in order to facilitate business formation, agglomeration, and increase in the relative market power of these enterprises (buying/selling groups, quality control systems).

### **Pro-poor CSR Strategies and Programs**

Encourage international joint venture partners to become import and adapt to Cuba the kinds of pro-poor CSR strategies that they practice in other parts of the world, especially in the mining, energy, and tourism sectors. For example, in Cuba Sherritt already contributes to physical and health infrastructure, and transportation. It could assist in local enterprise formation through sourcing and enterprise development like many mining companies do worldwide. *PDVSA* has programs aimed at encouraging SME growth in Venezuela through strategic purchasing and *Hoteles Sol Melia* has various economic development and sustainability programs worldwide. Cuban officials, however, remain wary of CSR because they associate it with the hegemonic tendencies of large capital and the return of “haciendas” and “company towns”.

### **Modernize and Open the Enterprise Financial Sector**

The financial services structure of Cuba is woefully in need of “updating”. Since Cuba is not currently a member of the IMF, the World Bank or the IDB (see Feinberg Op Cit.), it has little development capital available to it. Moreover, it has virtually no commercial and sovereign credit. Thus other types and sources of enterprise and development capital will be needed. Joint ventures with international microfinance and Impact Investment organizations should be explored.

In 2001, the PDHL pioneered an instrument for microcredits named Revolving Fund for Local Economic Development Initiatives (FRIDEL), which constituted Cuba’s first experience in making available soft credits in hard currency to local small and medium enterprises. A percentage of the profits reverted to the municipal government to spend on local development initiatives. FRIDEL was the direct antecedent of the Municipal Initiatives for Local Development (IMDL) Program established by the Cuban state in 2010. IMDL is a microfinance program for local state-owned enterprises to undertake projects that contribute to the municipal government’s local development strategy, substitute imports, enhance local management capacity and strengthen local production and value chains. Nevertheless, at present the IMDL microfinance mechanism excludes NSEs, insofar as the loans are in CUC (Cuban Convertible Peso) and NSEs are only allowed to hold bank accounts in CUP (nonconvertible Cuban peso). These restrictions may be lifted in 2013, at least for cooperatives and other forms of social property enterprises.

Vidal (2012) suggests several key ways of leveraging this microfinance system such as forming alliances with local organizations, NGOs, UN programs, universities, among other entities; the diversification of the services provided (e.g., start-up capital; micro-leasing, micro-factoring, remittances-linked services); and the establishment a microloan bank specialized in that market segment and/or allowed the creation of mixed capital microloan institutions. However, many more courses of capital will be needed.

The effects of remittances on Cuba's family survival strategies have been well studied over the years.<sup>24</sup> A new variant of this research will be the study of the role of remittances as business investment and as capital for the acquisition of tradable property such as cars and homes as permitted by the updated model. The amount of money that could be made available by leveraging these financial flows is considerable. According to the Cuban Research Institute (CRI):

...would-be entrepreneurs hoping to set up a new business in Cuba need an average of \$3,000 in micro-loans. If this estimate were correct, then creating 100,000 new businesses would require approximately \$300 million. This is equivalent to one-third of the amount relatives and friends abroad currently send to Cuba (CRI 2011).

So far, the Cuban state has welcomed remittances with trepidation about the loss of control over investment and credit sources they imply, and the effects of unequal access to these financial flows. Nevertheless, sources of capital that circumvent the US embargo are woefully needed. Increasing, managing and leveraging these financial mechanisms for business development and growth in manner palatable for both the Cuban state and the remittance-issuers, should be apriority of the state, though certainly, not an easy feat.<sup>25</sup> Assuring transparency in these financial flows would also facilitate tax estimation and collection.

### **Solve Wholesale Input Bottlenecks**

The clearest indication that the Cuban government is addressing this bottleneck came in March of in 2013. At that time, the Cuban government opened a state-run wholesale company to sell food products, industrial and other consumer goods to private companies and the state sector, a step aimed at meeting a key demand of local entrepreneurs. A regional network of such markets will be needed.

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<sup>24</sup>See also archives of: The Cuba Study Group, The Association for the Study of the Cuban Economy, the Cuba Project of the City University of New York's Bildner Center, the University of Miami's Institute for Cuban & Cuban-American Studies and the proceedings of Latin American Studies Association's conferences.

<sup>25</sup>The capture of remittances, financial flows intended to foster independence from the State rather than further dependence, will most certainly infuriate the remittance senders and receivers. However, state control may be the *sine qua non* for the state to allow a greater role for remittance as business capital.

## ***STEP 2 [FORWARD]: Transforming Some NSEs into SREs Through Knowhow, Capital, Partnerships, and Policy Incentives***

STEP 2 assumes, that the Cuban state will allow the type of enterprise-enabling support mechanisms outlined in STEP 1 to operate and take root. With this enterprise support, some NSE could then be either established as SREs or encouraged to transform into social enterprises. STEP 2 would require many coordinated efforts. However, here is an initial set of suggestions.

### **Foster Knowledge Networks/Hubs on SSEs/SREs and IMD**

Knowledge gathering must progress quickly from a “show and tell” phase to a “how to build your own” phase. The quickest way might be to piggy back pilot demonstration projects on to existing and new cooperation projects along the lines described above. The portals and documents mentioned earlier can also provide useful examples and linkages.

### **Speed Up the Process of Creating New Cooperatives in Non-agricultural Sectors by Adopting IMD and SSE Models as well as Adapting Franchising Business Strategies to Cooperative Ownership**

It has been clear for some time that the form of enterprise that will receive the most support (i.e. financing and legal frameworks) and become the most prominent in the NSE economy will be cooperatives (first, second and third tier). In December 2012, the Cuban government legalized, the creation of non-farm cooperatives. During the first phase of the experience, some 230 co-ops will be created in 47 sectors including transportation, construction materials and services, food services, fishing and domestic and professional services (specifically, translation, accounting and information technology). New co-ops will be permitted to conduct business with other co-ops, individuals, and state entities, and will be free to set their own prices except for those that the “State determines”. In addition, Cuba's government will lease out businesses like restaurants and other shops to be run by employee cooperatives. Construction co-ops were permitted in 2013. IMD and SSE business facilitating strategies would speed up their formation process.

The experience of the franchise sector in capitalist countries, a sector in which restaurants, salons, retail stores, hotels, etc. abound, offers many useful examples and readymade formats for the transformation of state sector services into cooperatives. Franchising increases the business success rate by lowering input costs and providing simple step-by-step business management systems to new franchisees. In essence, any service market that lends itself to franchising can be served by first, second and third tier cooperative systems by altering the ownership structure from private franchise to collective.



## **Solving Input Bottlenecks Through Social Enterprise**

The main bottlenecks in cooperative enterprise development will be similar to those of the NSE sector altogether—access to finance, wholesale goods, and retail/transportation distribution networks. Wholesale and “consumption cooperatives” could help alleviate wholesale/retail goods bottlenecks.

Ritter (2011) suggests the introduction of dealer-owned cooperatives in which large numbers of individual retail storeowners also own the larger enterprise. Besides the many economies of scale provided by these collaborative schemes, the type of business model could prove crucial in the conversion of state sector wholesale and retail entities into recuperated enterprises, in a number of economic sectors. This would facilitate a form of privatization through cooperatization.

## **Leverage of Financial Flows, Including Remittances, Specifically Targeted for the Development of Large or Second/Third Tier Cooperatives and Social Enterprises**

In order to leverage financial flows for development purposes closer links between remittances and enterprise development programs are needed. For example, links between micro finance institutions and remittance issuers, perhaps similar to Kiva should be explored. This leveraging might be more palatable to the Cuban state if some of the funded enterprises are social enterprises that direct a portion of their earnings and of their services to hiring or serving targeted or marginalized communities. We call this approach, “Remesas Plus”.

Large cooperatives such as wholesale cooperatives, as well as worker-owned recuperated enterprises (*empresas recuperadas por sus trabajadores or ERTs*) in industrial sectors are simply too large for ad hoc financing and/or for the limited coffers of the state. These enterprises will need capital with which to buy or “recuperate”, as well as operate these enterprises (e.g., working capital, plant and equipment). Joint ventures with international microfinance and Impact Investment institutions, or remittances channeled through investment-oriented state banks could provide some of these funds. This strategy will foster the successful transformation of large portions of the inefficient and antiquated Cuba state economic apparatus into NSE-based SSEs.

## **Promote Supply Chains Formation with Links to Solidarity National and Export Sector**

The entire sugar sector has been recently opened to international joint ventures with the state-run sugar monopoly AZCUBA despite concerns over the US Helms-Burton law. This is good news for the provision of adequate capital to modernize production. Given the current scarcity in world markets for organic fair trade sugar, growing the established capacity of this sector is a most promising. Since fair trade

organic products requirement a laborious learning curve, the members of these pioneering sugar cooperatives should be encouraged to diversify into other fair-trade products and to provide advice to other potential growers. A thorny issue for the Cuban fair trade sector is that the mechanism for the efficient distribution of the fair trade premium to the cooperatives remains inadequate.

The fisheries cooperatives being promoted by the Environmental Defense Fund (EDF) and COSPE have the added advantage of fostering sustainable coastal zone and resource management.

### **Proactively Establish Cuba-Adapted Pro-poor CSR Projects**

Rapid contributions to the state's food security/import substitution agenda can be made through pro-poor CSR strategies. The purchase power of the tourism sector is key in these developments. Policies in effect that promote direct purchases of fresh produce from agricultural cooperatives by tourism hotels and restaurants are a step in the right direction, although hampered by the condition that payment be made in nonconvertible pesos (CUP) because these NSEs cannot hold hard-currency (CUC) bank accounts.

Besides the developing projects with existing international commercial and investment partners, new partners could be sought with pro poor CSR strategies in mind. For example, consumer goods firms with representation in Cuba like Nestle, invest in coffee growers in a number of countries, and could be encouraged to establish a pilot program in Cuba in this sector. Others such as the *Cadbury Cocoa Partnership* a multi-sectorial initiative designed to secure the sustainable livelihoods of a million farmers in cocoa-growing communities across the world could be invited to explore partnerships with cacao-growing cooperatives in Baracoa. Though fears of US retaliation via legislation such as Helms Burton might inhibit direct investment in Cuba, many forms of informal learning and networking can occur.

It should be noted that CSR in Cuba is considered an oxymoron by observers, the vast majority of them living outside of Cuba, who oppose the Castro regime as well as The Cuban state's foreign investment labor practices.<sup>26</sup>

### **Developing Legal Frameworks for “Benefit Corporations”**

The promotion of “micro social enterprises” must be done with care not distort markets further at the local or micro level, nor impose additional costs and market burdens on entrepreneurs. There are legal frameworks (i.e. Benefit Corporations), policy mechanisms (e.g., tax breaks, preferential access to capital), and private certification-based programs (i.e., B Corps) that, if integrated, can encourage the development of a profitable and sustainable SRE sector right from start. In capitalist

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<sup>26</sup> See Cuba (2006).

countries, leading edge thinkers are attempting to create just such mechanisms. Cuba could become a very unique incubator of such innovative enterprise models.

### **Take Advantage of Cuba's Excellent Educational Infrastructure to Massify Business Education**

Basic business education can be made available in order to spark interest in becoming an entrepreneur, provide the basic tools for success, and the foster the growth of small enterprises into more complex SMEs. Exchanges and internship programs with business schools worldwide (e.g., MBAs Without Borders) can be encouraged to consider Cuba a destination. Technical and business training is a key component of many SSEs/SREs and IMD international networks.

### **Capture the Learning Curve of Cuba's Pilot SREs**

The creation of the policy and legal frameworks that can support SREs will take much debate and possibly years in the making. However, a number of research actions can be taken immediately to help the state understand the importance and contributions of SSEs/SREs as a component of future development model.

The enabling environment created by UNDP's PDHL and now IMDL, as well as the pioneering efforts of the Office of the Historian of the City of Havana (OHC) have spawned a number of SSEs/SREs in the provinces and municipalities where it has operated. A new breed of socially responsible entrepreneurs has emerged inspired by spontaneous feelings of solidarity toward their neighbors and co-workers, and sense of community belonging, rather than knowledge of the principles of solidarity economy or the movement that promotes it. Examples of these new NSE-based SRE phenomena in Old Havana are as follows: (1) the restaurant *La Moneda Cubana* sponsors community projects that teach restaurant skills to local unemployed teenagers and finds jobs for graduates; and (2) Gilberto Valladares's (aka "Papito") hair salon, *Artecorte*, also hosts a museum dedicated to the history of hairdressing in Cuba, and a hairdressing school. *Artecorte* facilities include formerly abandoned buildings donated by the municipality, where neighborhood youths learn "the skills of the trade and the values of citizenship". Papito's neighbors are now engaged in urban renovation such as a children's park, and a sports court.

Some Cuban NGOs, like Fundación Antonio Nunez Jimenez (FANJ) and the Center for Exchange and Reference Community Initiative (CIERIC), and professional organizations like the National Union of Architects and Engineers (UNAICC), have pursued various pilot SSE/SRE projects and initiatives. CIERIC, for example, is championing self-sufficiency in the cultural sector—one of the traditionally subsidized public sector services along with health, education, social security and sports—supporting local artists, musicians and other cultural activists in pursuing income-generating activities that have positive spillovers for the development of

their communities. UNAICC is promoting the production of local building materials and low-cost housing construction, turning workshops and building crews created through international cooperation projects into self-sufficient cooperatives.

A number of research efforts by the OHC, the ANEC, the CEEC, and Quebec's Chantier de l'économie sociale are currently capturing and disseminating findings associated with the learning curve already traveled by Cuba's few social enterprises.

### **Take Advantage of Social Capital in Communities**

As the examples above demonstrate, social economies frequently arise out of natural associative factors such as family, ethnicity, gender, age. Of special interest to this study is Adrian Hearn's ethnographic work on the development of social capital and in the Cuban-Chinese community (Hearn 2012), and the Christian and Afro-Cuban religious communities (Hearn 2008). In the case of the religious communities, Hearn shows how, as a response to the crisis, the communities, state agencies and foreign NGOs began to collaborate around development projects. Hearn's work on Havana's Chinatown suggests that this community has a well-entrenched, successful and highly entrepreneurial informal business sector which is leveraging the benefits provided by the overseas Chinese community. Recently, these communities have been experiencing the encroachment of the state's bureaucracy on its informal business dealings and community practices as the NSE sector gets formalized. There are signs of tensions with the state just at a time when their social cohesion and business track record should be taken advantage of and leveraged in the process of spurring the rapid growth in the NSE sector. The difficulty of adapting to Cuba's economic bureaucracy may far outweigh the benefits of being assimilated by it. Unfortunately, these communities may not be offered a choice. These case studies deserve careful examination, because there are many other informal networks, some cross-national, that could be leveraged (family networks, LGBT, Jewish community, etc.).

### **Develop Social Enterprises in the Social Services Sector**

Social enterprises are also quite common in the social services sector (elder care, patient care, education and training, etc.). So far, the Cuban state is only starting to allow self-employment in this sector (e.g., childcare). An easy market to serve through small cooperatives would be that the provision of eldercare. Elder care is a prime target for this type of arrangement given the demographic trends in the island. Moreover, elderly Cuban migrants are finding it difficult to maintain quality of life in the midst of deepening economic crises and reductions in old-age benefits in their new countries, prompting interest in returning to Cuba to live out their remaining years. In order to address social equity concerns, some of the eldercare cooperatives could be set up as B Corps—their articles of incorporation explicitly designate a portion of the profits of the manpower hours for the training of eldercare workers and for the care of elderly without access to CUCs.

Quebec's successful trajectory in funerary cooperatives is currently being explored in Cuba. A chain of Cuban second tier or third tier funerary cooperatives could easily become net remittance earners, as well as hubs for local networks of first tier cooperatives of flower growers, casket makers, transport services, caterers, cemetery grounds keepers, etc. In order to maintain the solidarity of the sector, a portion of the earnings of the second tier cooperative would be set aside for low-income services to the surrounding communities and/or for training.

### **Develop Special Programs Targeted Towards Youth**

One of the most pressing needs in Cuba is to develop programs for youth. The construction, one with rapidly growing CUC demand, is great need of skilled tradespersons. Vocational training (*escuelas tecnológicas*) is an integral part of Cuba's educational system and many see it as a fast track to enter the NSE workforce. Unfortunately, state finances are stretched. Small vocational schools with paid, on the job training, could be quickly established in cooperatives and communities if funded by the state (directly or through fiscal incentives) in partnerships with NSEs and *Remesa Plus* schemes (a portion of the remittances is directed towards training). *La Moneda Cubana* and *Artecorte* are great examples of the viability of self-financing vocational social enterprises. International cooperation could play a key supporting role by providing educational development funds and know-how in trades and management. Special schemes targeted towards the integration of youth into the tourism sector or into the fair trade organic production sector through NSE-based value chains are quite feasible.<sup>27</sup> Special development programs for youth also exist for fostering social entrepreneurship.<sup>28</sup>

### **Foster Solidarity Through Non-collective-Property Models**

From a business efficiency point of view, not every enterprise can best thrive as a cooperative. Therefore, other ways to "socialize" enterprises and build solidarity mechanisms must be found and encouraged.

"Peer lending" schemes—the most common of which is microcredit—provide a financial intermediation-based form of group solidarity. These schemes allow for individuals who have their own micro/small businesses in a number of different industrial sectors to become associated through a common debt obligation rather than through the common ownership of only one enterprise. This could permit communities and city bloc residents to come together through peer lending schemes that can support a variety of small enterprises. An additional benefit is that these schemes permit low collateral requirements.

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<sup>27</sup> For example, by joining WWOOF a worldwide network of organizations in 100+ countries that links volunteers with organic growers.

<sup>28</sup> For example the Social Entrepreneurship Targeting Youth in South Africa (SETYSA).

In Europe and North America “car share” schemes are quite common. In essence, individuals become members of an organization that manages a fleet of automobiles that the members can have pre-arranged access to and for which they pay per trip. Construction and automobile-repair tool sharing cooperatives, as well as those providing specific industrial or business equipment/services (e.g., copy machines, cleaning machines) could also be quite easily formed and very useful. The franchise model cum cooperative enterprise approach discussed earlier could provide innovative solidarity models while also helping to solve retail sector bottlenecks.

### **Encourage a Greater Number of Foreign Assistance NGOs in SRE, SSE and IMD-Oriented Programs**

According to Feinberg (Op cit): “The overall amount of economic assistance [available to Cuba] is too small to have a macro-impact on economic growth, but at a micro-level, there is evidence that foreign assistance can make a positive difference.” In the case of Cuba, the kinds of enterprise fostering programs that PDHL, CARE and Oxfam have been promoting can be replicated and new pilot SRE-forming enterprises established. Development assistance agencies of Switzerland (COSUDE), Spain (AECID), and Canada (CIDA) and the Canadian Embassy’s Local Initiatives Fund—have also supported many SRE initiatives proposed by existing civil society organizations, agricultural cooperatives and local governments. But actual international cooperation support for NSEs has not been attempted. This will require a new openness by the Cuban government to this kind of foreign assistance and NGO cooperation. The recent approval of nonagricultural cooperatives could pave the way for this.

However, before this can occur on large scale, NGO legislation will also have to be “updated”. Betancourt (2012) points out that since 1996 there has been a virtual moratorium on the legalization of new associations in Cuba and that the existing legislation regulating civil society organizations is fragmented, incomplete and outdated. It favors the stability of “associative elites” and grants excessive discretionary powers to government organs of relation.

### ***STEP 3 [BACKWARDS] The State Must Step Back and Allow Other Agents to Lead; and the Other Agents Must Step Back and Let the Cuban State Lead***

On the one hand, SRE and SSE experiences worldwide demonstrate that civil society must be the primary agent behind enterprise formation dynamics with the state playing primarily an enabling role. Even IMD multi-sector approaches understand the importance of broad-based civil society participation in development. Cuban planners must resist the temptation to control and intervene directly in the NSE sector. Moreover, the basic management paradigm must reverse from top down to bottom up. For example, there is a great deal of accumulated business knowledge in the

informal sector and in the cooperative farm sector. It would improve the success rate of new NSEs to allow these individuals to contribute substantially to the process of national enterprise development programs and enabling policy environments. Lastly, planners must resist the habit of always putting social objectives or national economic objectives before enterprise level economic health. Causing enterprise death by taxes, fees and import duties, and red tape will bring a sense of déjà vu of the late 1990s that will discourage risk taking.

On the other hand, international IMD, SRE, and SSE advocates, will have to arm themselves with the patience of Job. The Cuban bureaucracy is notoriously slow and capricious. The adage “You can’t fight City Hall” is nowhere more applicable than in Cuba and in other countries at the bottom of the “Doing Business In” rankings. Moving from a “show and tell” phase into a “how to build” phase will require a skillful combination of: (1) respect for Cuban sovereignty and its socialist tradition; (2) a constant awareness of the similarity of this discourse with that of Track II regime change; (3) sensitivity to “politically-correct” semantics and terminology; (4) respect for spaces and activities reserved for nationals, where foreigners must tread with caution; (5) the willingness to take risks, be flexible and go “outside the box”; (6) a long term relationship building approach; and (7) a capacity to take advice, criticism, and often accept decisions without satisfactory explanations.

### **Conclusion: (IMD Enabled) NSE + (Policy Facilitated) SREs (Could Indeed) = SSEs (But Only if the NSE Sector Is Allowed to Grow Much Faster Than It Is)**

The Cuban government is currently formalizing its “updated” economic model. When this model is unveiled and subjected to popular discussion—as was the *Lineamientos* project—we will see how far the principles of SSE/SRE and IMD are built into the model, and whether public opinion advocates to their greater presence. The arguments presented thus far in this paper, hopefully, have provided a convincing logic that suggests that Cuba’s current domestic market opening within a socialist framework provides a unique opportunity to foster the formation of economically viable NSE-based SSEs at a national level, and that, in fact, this is happening, despite daunting challenges.

The basic ingredients are in place. On the one hand, there are useful international SSE/SRE and IMD models that can be implemented, as well as partners interested and willing to engage in Cuba if they are given the operating space and the right collaborative conditions for success of their programs. On the other, Cuba has one of the most essential elements in the long-term success of these models—a strong national government committed to social and environmental objectives and to a cooperative tradition, as well as highly educated citizens who have shown extraordinary ingenuity and entrepreneurial spirit in their capacity to “resolver” (inventively solve). The success of the pilot projects and citizen initiatives described in this paper bode well for the successful adoption of these concepts.



Even if Cuba did not want to change, at heart, circumstances will force it to change—First and foremost, because the Cuban state is bankrupt. It has neither the international credit nor the access to multilateral funding required to support the growth of NSEs through either direct investment or stimulation of demand. The adoption of SSE/SRE and IMD models would open a multitude of new sources of international know-how and financing, as well as to webs of international solidarity-based preferential market access and consumer demand. Second, the social benefits and solidarity objectives of SSE enterprises are supported by business success rather than by state coffers or international assistance. This financial self-supporting dynamic of socially committed SSE/SREs can provide a lifeline to the Cuban state while it revitalizes its economy through a combination of a strong and strategic state sector and market means, without having to abandon its commitment to social welfare.

The dangers are many. However, four stand out. First of all, Cuba's economic lifeline—subsidized Venezuelan oil supplies—is at risk of being stopped or significantly reduced by a possible discontinuity in the oil subsidy policies established by Chavez. The effect such an external shock on a feeble economic recovery might mean the return to some of the least savory aspect of the Special Period. Second, the risk of succumbing to the kind of “mini-cowboy capitalism” that thwarted the former Soviet bloc's inclusive and sustainable development is always near at hand. Third, the updating process could be derailed all together by a perfect storm that combines the concerns of some very influential individuals, with those of some very symbolic ones for the Revolution. The influential individuals are the current beneficiaries of the system (mostly state bureaucrats and joint venture managers) who are concerned over the potential loss of power and privileges that a non-state sector controlled economy implies, not to mention the real fear that they may end up unemployed and underemployed in an economic reality without an upside for them. The symbolic individuals are the citizens with either less access to CUCs or less capacity to thrive in an entrepreneurial economy. A combination of “bureaucratic insurgency” and populist politics aimed at the discontented could destabilize the regime. Fourth, alternately, those who today control important sectors of the state economy could conceivably join forces with the country's burgeoning capitalist class, as well as with the Cuban expatriate class eager to recover its former wealth and predominance. Since the USA has never renounced the dream of rolling back Cuba's socialist revolution, the hardline anti-Castro lobby is most likely busy confabulating all manner of schemes to derail efforts to craft a new and autochthonous economic model that employs the market to uphold and improve socialism, instead of abolishing it.

Cuba has a tendency to engender “bi-polar ideation” in people—wide swings between utopian and dystopian thinking. For some, Cuba has been a beacon, a bright spot in the search for social justice. For others, it has been, and still is, a tropical Gulag, whether individuals are incarcerated or not. The debates about the desirability of the combination of SSE/SRE and IMDs and Cuba's NSE sector could easily suffer the same fate. For some, it will deliver the best of both worlds—*The New (and Improved) Cuban (Wo)Man*. For others, it is likely to result in the worst of both worlds—a *Cronus Economy* that devours its children in infancy. But Zeus



may survive after all: Cuba could conceivably have its cake, and eat it too. But this will take conscious design, bold steps and luck. The first steps have been taken many more must follow, and fast. The welfare of millions of Cubans is at stake.

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# Chapter 12

## Concluding Reflections of the Current Reform Process in Cuba

Ricardo Torres Pérez

Beyond the specifics of the economic transformations in Cuba, one of the big opportunities of this moment is the chance to generate a long-term program to begin addressing some of the most acute contradictions in Cuba's current economic development. Following is a brief discussion of some of the most interesting challenges that Cuba is facing. This analysis focuses on four significant areas of contradictions that should serve as the foundation for economic development; performance in these areas must improve substantially in the coming years if we aspire to reverse Cuba's significant accumulated problems.

### Underutilization of Human Capital

Although the concept of human capital is controversial, the majority view is that Cuba has a relatively high level of this factor, especially compared to most underdeveloped countries. In 2010, island residents averaged 10.57 years of education (Barro and Lee 2010), the highest level of any country in Latin America and the Caribbean and one of the highest in the developing world (only behind South Korea and Taiwan).

Indicators from the Human Development Report published by the United Nations Development Program (UNDP) also bear this out. One of the three components of the Human Development Index is education, in which Cuba shows high levels of educational attainment, again greater than Latin America and most of the developing world (except former socialist countries and some East Asian countries). This achievement is especially significant because it includes the entire population, regardless of region or family income levels.

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Nevertheless, this progress is not reflected to the same degree in the country's economic performance. For indicators of economic growth (GDP and GDP per capita, labor productivity), increase in exports and changes in their structure, Cuba's rates are mostly below the average for the region and other similar countries. Moreover, transformation of the productive structure toward a low-productivity service economy does not reflect the benefits of an educated workforce; rather, it is indicative of underutilization of the skills invested in the workforce. Although there is clear circularity between the two phenomena (more growth generates more resources for education, which in turn prepares the workforce to carry out activities that are more complex or have greater efficiency and efficacy), there are several factors that can explain this imbalance.

First, there have not been similar degrees of progress in other areas that are complementary to the development of human capital, such as training in technical specializations, resources dedicated to Research and Development (R&D), patent filings, or publications in leading journals. Although in some of these areas Cuba has attained higher levels than other developing countries, the results are below what would be expected given the investment in formal education. Furthermore, the collapse of investment during the economic crisis and its subsequent insufficient recovery suggest that a necessary complementarity between available quality and quantity of productive factors has broken. Finally, in the last 20 years, Cuba's greatest employment generators are not exactly sectors distinguished by the complexity of skills required in the workforce, which implies a "de facto" underutilization of the training received.

This suggests that although the general outcome is broadly favorable for Cuba in creating "human capital," the complementarity among its diverse components must be addressed, incorporating those skills required for a qualified workforce in the twenty-first century. Greater effort needs to be given to training in foreign languages and infrastructure related to Information and Communication Technologies (ICT); these are areas in which Cuba has fallen seriously behind its comparators (CAF 2011). This is an urgent task given the demographic profile of the Cuban population. Cuba's population is aging and there are high levels of external migration; these two factors combined with the expected reduction in the workforce in the coming years means that a substantial part of future economic growth will be based on productivity growth and increased investment rates.

## **Underutilized Natural Resources**

Although Cuba has historically been considered relatively poor in natural resources, this view should be reassessed in light of their actual use. The insufficiently exploited wealth includes land, metals, water, fishing stock, beaches and other tourist attractions, and renewable energy sources, among others.

Cuba has one of the lowest rates of agricultural land per capita in the region (Ludena 2010); exploitation of this factor is well below the possibilities provided by

modern technologies, given the adequate supply of complementary assets for agricultural activity, such as workforce (quantity and skills), physical infrastructure, water, market, technologies, etc.

This is perceptible in the proportion of idle land that has agricultural value but is not cultivated. This indicator has varied in recent years between 20 and 30 % of farmland, which reflects the poor use of this resource. Additionally, even when a significant percentage is declared pastureland, the performance of cattle and goat livestock indicates that these wide expanses, which represent the majority of arable land, are also very deficient. Finally, there has been a reduction in the amount of uncultivated land through the establishment of new regulations that facilitate land transfers to new producers, but the lack of other resources such as credits, technical training, machinery and other problems suggest that of the parcels transferred to cooperatives and individuals, a high percentage have still not been put into production.

Moreover, the low yield of most of the crops, compared to similar countries,<sup>1</sup> is another aspect of this contradiction. This is especially serious given the sociodemographic evolution of the Cuban population over the last 30 years and its future trend. The empirical evidence shows that increases in yields and labor productivity in agriculture is what meets the food needs of a population, provides new opportunities for progress in rural zones and frees labor to be employed in other sectors that are equally necessary for modern society, such as transformative industry and more recently, social and productive services. This becomes a necessity when the levels of available labor are low in a context where the productivity in other sectors is not very high.

This poor performance in agriculture translates into high real cost of foodstuffs and significant penetration of imports to satisfy basic food needs. The cost of the basic food basket is a serious obstacle for raising the purchasing power of workers' income. Additionally, food, along with energy, constitutes the most important dimension of the import structure, representing 15–20 % of such outlays (ONE 2012). Given that food imports are very inelastic components of expenditure, they decisively contribute to generating recurrent balance of payments disequilibria, at the same time that they impede using import financing for other components with greater impact on economic growth and productive transformation, such as capital assets.

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<sup>1</sup>In a comparison of Latin American countries (Argentina, Bolivia, Chile, Colombia, Costa Rica, Ecuador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Dominican Republic, Trinidad and Tobago, Uruguay and Venezuela) of five basic products (rice, beans, plantains, potatoes and tomatoes), Cuba had average values for beans and potatoes, whereas for the other three it had the lowest levels (shared in some cases). For more details, see FAOSTAT, [http://faostat3.fao.org/home/index\\_es.html?locale=es#COMPARE](http://faostat3.fao.org/home/index_es.html?locale=es#COMPARE)

## **Low Mobilization of External Savings in a Context of Insufficient Domestic Resources**

Underdeveloped countries typically have low productivity, which sets conditions for low levels of consumption, and especially, investment. At the same time, some countries are beginning to experience the impact of an adverse demographic profile, which tends to depress domestic savings even more. Cuba has not escaped this reality, and for more than 20 years, following the loss of external resources from the Soviet Union and the Council for Mutual Economic Assistance (CMEA), the country has maintained very depressed rates of accumulation, averaging 12 % of annual GDP (ONE 2012), which is far below the necessary rates for accelerating growth, replacing productive capacity throughout the economy, repairing and expanding the physical infrastructure and sufficiently incorporating new technological platforms for modern societies, such as ICT.

Given the restrictions that the country faces in accessing the international financial markets, the estrangement of the principal institutions that provide development credit (World Bank, Inter-American Development Bank, Latin American Development Bank, among others) and the country's own credit history, international financial flows are key to the nation's short and long-term development. Attracting Foreign Direct Investment (FDI), is especially important, given the conditions outlined above; the amounts of FDI in the last 22 years have been well below that obtained by other developing countries, even discounting the negative effects of US policy. Recent estimates (Feinberg 2012) are that foreign investment per capita has been about US\$300 in Cuba, half of the level in Nicaragua, the Latin American country that has the next lowest amount. This analysis also corroborates what has been known for a long time: the smallest countries depend proportionally more on foreign resources and trade than larger economies.

In the current global context, FDI can substantially contribute by attracting capital, technology, opening new markets and insertion into international value chains, employment creation, transformation of the productive structure and expansion of the infrastructure, distribution of risk, and increased confidence in the country's economic strategy, among other contributions. What is required is to gradually correct this inconsistency through a proactive and strategic policy toward the foreign investor, at the same time providing greater transparency and agility for negotiations, which would facilitate maximization of the domestic economic and social effect.

## **Small Developing Country with Poorly Developed Export Capacity**

The available data shows that trade represents an increasing proportion of total production. This trend has occurred in the vast majority of modern states, however, small countries have been historically much more dependent on the foreign sector

than the large powers, given the limitations of scale imposed by small domestic markets. This condition has often been an impediment for many underdeveloped countries, which has stimulated an intense theoretical debate and debate within economic policymaking. Nevertheless, although for many it has been an obstacle, there are successful experiences that have been able to transform this structural issue into an opportunity and means for accelerating economic growth, productive transformation and modernization of their societies. The most recent classic examples are found in Asia (Singapore, South Korea, Taiwan, China, Malaysia), as well as in Europe (Ireland), Africa (Mauritius), Oceania (New Zealand) and Latin America (Chile, Costa Rica, Uruguay).<sup>2</sup>

Cuba stands out on this measure with a recurrently high import coefficient (Vidal and Fundora 2007) given low export dynamism, which leads to a persistent trade imbalance that is especially difficult to finance with the country's particular conditions. Even within the Latin American region, its export performance is seriously lagging,<sup>3</sup> which is disturbing, given that the region is not especially noteworthy for its success in international markets (with some exceptions). This situation also extends to other areas, such as finance, technology transfer, transportation and communications. This combination reinforces a development style in which many of these elements are not at the center of the economic policy agenda. The problem stems from the fact that under current conditions there are no real opportunities for advancement without engaging greater integration with the global economy. The international economy is increasingly transpiring through involvement in multilateral spaces, where mutual benefit and complementary action take precedence, including new spaces for integration in Latin American and the Caribbean, as well as other mechanisms, such as the European Union.

## Final Reflections

Considering the magnitude of challenges that face Cuba and the adverse internal and external conditions, it is practically impossible to expect fast improvement in the country's short-term economic performance. That would be a false referent for judging the progress of the economic transformations process. Nevertheless, if these changes facilitate comprehensively and systematically approaching the country's contradictions, including those that were previously debated on the economic level, it could be argued that the current reform is an opportunity to construct a more prosperous country.

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<sup>2</sup>For a detailed study of these experiences see The World Bank (2008).

<sup>3</sup>See CEPALSTAT at <http://websie.eclac.cl/sisgen/ConsultaIntegrada.asp>.

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# Chapter 13

## Moving from Reacting to an External Shock Toward Shaping a New Conception of Cuban Socialism

Juan Triana Cordoví

Like the opening that began in the 1990s, the current updating process was triggered by external conditions. What we are now calling the “updating of the economic model” is the result of events unfolding in mid-2006 that created the necessity to address an adverse external situation:

Since 2005 it has been evident that the economy has been unable to manage the balance of payments capital account deficit, international transfers of foreign reserves, and the high level of foreign debt payments; all of which meant significant tension in managing in the economy (Lineamientos 2011).

The process begun in 2007 has gone through phases: from focusing on urgent problems (putting uncultivated land into production, adjusting imports to deal with the current account crisis, etc.) and a first round of elimination of prohibitions (allowing Cuban residents into hotels, legalizing the sale of cellular telephones, etc.), to developing a more comprehensive vision for transforming the economy and society (the economic and social Guidelines), popular consultation, approval at different levels of government (Party and State), the creation of an institution with special authority over the implementation and monitoring of the process (the Implementation Commission), the subsequent establishment of a Scientific Technical Advisory Council, and the definition of more than 50 research fields in which more than 40 Research Centers and Universities are working. Thus, it has been a process of continuous learning and institutional innovation.

Unlike the opening in the 1990s, the new aspect of the 2007 process, as confirmed in 2011, is political and ideological assimilation of the need for change as a critical aspect for the continuity of Cuban socialism and the relatively open willingness to examine all means that could facilitate sustainability of that socialism (the details of which have yet to be defined).

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Institutional strengthening, including reorganization of the State and Government. Emphasis on the idea that the economic plan should be adapted to available resources.

Prioritizing growth and diversification of exports and import substitution, designing special programs and measures in support of this priority, especially closed financing schemes that allow decentralized use of foreign currency.

Review and reorientation of investment policy to make it more comprehensive, avoiding resource immobility and other inefficiencies. To this end, available foreign credit was redistributed toward short-term objectives with greatest impact on the balance of payments.

Refinancing payments on the foreign debt. Agricultural sector structural and functional transformations; for example, Decree Law 259 on leasing idle state lands, in order to increase food production and reduce food imports.

Additional measures to reduce energy consumption, including organizational approaches, such as the reorganization of freight transport.

Initiation of a significant group of industrial investments that are strategically important to the country's development.

To relieve the State's burden for some services, experiments such as: substituting worker cafeterias and transportation for other modalities, renting barber shops, beauty salons and taxis to those employed in those activities.

Moreover, there is now certainty that along with updating of the model and defining how the economy should function (the definition of a model of the functioning of the economy) there should also be a sufficiently clear development model for the country.

## 2013: A Decisive Year?

Most certainly, 2013 should be a decisive year for the advance and possible consolidation of the "updating" process and all the reforms and changes that it requires. At least four of these policies should have short and medium term impacts:

1. New tax law.
2. Immigration law reforms go into effect.
3. Experiments in the state enterprise sector
4. Start-up of experimental cooperatives outside the agricultural sector. Additionally, two other measures initiated in 2012 should show results in 2013:
5. Decree-law 300 covering leasing of idle land.
6. Measures approved to free-up the operations of the Basic Units for Cooperative Production.

The new tax law seeks a difficult equilibrium among the objectives of introducing a *taxation culture* to the population, which has low levels of income, a *clearly revenue generating purpose* based on raising rates rather than expanding the tax base, an effort to *stimulate the new private sector* and the political constraint of

avoiding “concentration of wealth.” The last will be difficult to achieve even with the new law, which sets the amount of 50,000 Cuban pesos annually (2,083 CUC per year, or 173 CUC per month) as the level of income above which self-employed workers are taxed 50 % of income. The policy limits the creation of capital and the expansion of these businesses through self-capitalization.

This presents a dilemma that is neither fiscal nor redistributive; rather, it is conceptual. The goal is to make the idea of limiting the concentration of wealth cohere with the practice of creating a medium-income sector with capacity to generate employment and take on productive functions that complement the state sector and create new “linkages” that contribute to an improvement in the system’s efficiency and productivity. The question is, how can this be achieved if there are limits to the technological complexity of self-employment and at the same time the capacity for private accumulation is restricted to very low levels, both of which are essential elements for improving the quality of these jobs and new businesses? The maximum income not taxed at the 50 % rate, 50,000, leaves little margin for “new businesses” to consolidate, thus weakening potential sources of national private accumulation and favoring “imported” private accumulation via remittances.

The other negative effect is the incentive for tax evasion through underreporting of income, using fronts or undeclared “leasing” of equipment and materials. The fiscal arrangement and its associated policies are without a doubt issues that need to be reconsidered in the future.

Implementation of *changes in the immigration law* is another measure that reflects the political will invested in the process.

The changes in migration policy can positively affect remittances by encouraging temporary exit in search of work. This also relieves the pressure on the Cuban labor market; currently, employment can only grow through the non-state sector since the capacity for the State to generate employment is very low.

The possibility that any Cuban, with the exception of probably less than 1 % of the population, can freely travel and return at will (requiring only biennial passport renewals) means that Cuba can even become a systematic “sender” of tourists for the first time in 50 years. This will not have a significant impact on the current account, perhaps only for tourism income from July and August, since Cubans with sufficient income (who are the principal clients of national hotels in those months) can travel to other Caribbean islands for lower prices and receive much better services than those offered in Cuban facilities.

However, in general the net result of this measure is positive, at the political level for the country’s image and for the Cuban family, as well as for its probable effect of increasing remittances and reducing demand for jobs.

*Proposed changes to the state enterprise system* are the most significant, since that is where the country’s economy and a substantial amount of its employment is concentrated. The experiment will cover a small number of firms and high-level business management organizations, chambers of commerce, self-financed research centers and high technology businesses. This small group of entities (which include *Azcuba*, *GAE de las FAR*, *Biocubafarma*, etc.) is critical to the Cuban economy. More than 70 % of profits produced in the country are concentrated in less than 6 % of firms, and almost all of these are included in this process.

The idea is to *increase the autonomy and capacity of state enterprises' economic and financial management*. This is a long-running unmet goal, dating from the 1970s when Cuba had its first “opening” under the System for Economic Management.

The following objectives have been identified: facilitate recapitalization of firms, use part of increased profits to raise workers' salaries, promote the creation of a wholesale market allowing firms to freely sell surplus goods after fulfilling the state requirement, and assure that international prices are accurately reflected in the costs of state enterprises. These are all common aspects of firms operating anywhere in the world, but have not been permitted, or have been significantly limited in Cuban state firms.

Another change involves the procedures for approval of a firm's “social objective,” one of the most important barriers to business competition in Cuba. Under the new philosophy, a firm's social objective will be determined by the organization or agency that runs the enterprise, whereas it had been the purview of the Ministry of Economy and Planning. Additionally, the Ministry will not define the currency for a firm's operations, as it did previously, which was substantially constraining, and directors of a business or entity will be able to make decisions about a firm's secondary activities, issues that are still within the mandate of the Ministry of Economy and Planning.

After experimenting from 2013 to 2016, the experience will be extended to the rest of the enterprise system and will be the basis for developing a Business Law. The splitting of the system into firms that are participating in the experiment and those that are not could introduce significant deviations and bottlenecks that undermine the true significance of what is achieved. Moreover, waiting 3 years to establish the Business Law could lead to significant costs to the goals for reform process improvements and their real impact on the economy's performance.

Another consideration is the factor of time. As long as experimentation is the “logical” path, the time it will take to achieve generalization and a new business law in Cuba could conspire against another purpose of the updating—achieving higher levels of economic growth.

Another important measure in 2013 will be the creation, also experimentally, of cooperatives outside the agricultural sector. In the experimental period, 220 cooperatives will be formed, mostly in the retail sector for agricultural products, fishing and construction. Thus, the professional sector's aspirations of finding legal means to practice the professions outside the state will have to wait.

The mechanism designed for instituting these changes requires a long process of intermediate decisions that ends with approval from the Implementation Commission. What is new for Cuba is that the regulatory decree also stipulates that state contracts will be awarded through public auction, a practice that is quite unusual for the country.

The reforms for “updating the model” cover other actions, such as:

- Preparation of the long-term foundations for the Economic and Social Development Program;

- New methodologies for wholesale and retail pricing;
- Adoption of monetary policy instruments to maintain control over the money supply; and
- New procedures for financial planning.

## Results

In terms of economic growth, most importantly, capacity for maintaining growth continues despite the implementation of a very strong import adjustment policy.

Nevertheless, the average rate achieved over the last 4 years is relatively low and is still far from the country's needs (Fig. 12.1).

Better results are observed qualitatively. Growth has been concentrated in productive sectors, especially in 2013; moreover, even as investment continues to be deficient, it is reallocated to functioning productive and service sectors, some of which the country needed, and which is consonant with the Cuban productive sector's need for recovery.

Another significant result is in employment generation. In the last 2 years, the non-state sector, especially the self-employed sector, has been the greatest, indeed, the only employment generator in the country, with more than 200,000 new jobs created in 2011. This also has a positive impact on individual and family life projects, compared to several years ago, since today there are means for significantly improving income and quality of life without resorting to the expedient of emigration, which is very positive considering the demographic squeeze that Cuba is facing.

Diversification of available goods and services that are legal alternatives to the state sector has produced the intangible result of creating relatively stable supply

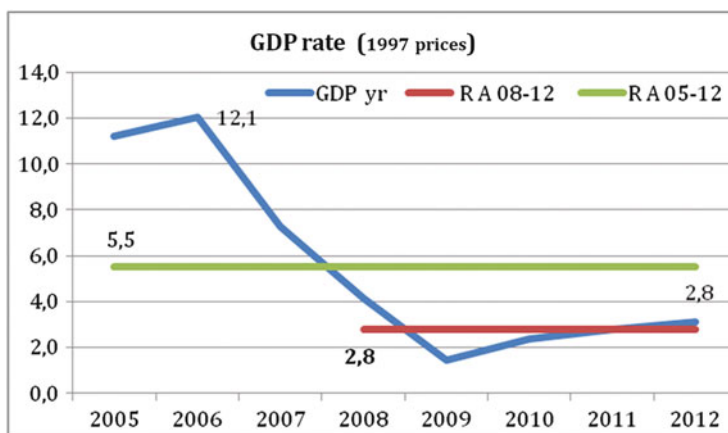


Fig. 12.1 Growth in GDP

chains (especially in the case of supplies of agricultural products to restaurants), demonstrating the viability of de-Statization and decentralization.

Other intangibles resulting from this phase in the transformation are, first, the consensus that without development it will be very hard to sustain Cuban socialism. This is a departure from the past in which socialism was the guarantor of achieving development; in the current view, assisted by reality itself and supported by the highest levels of decision-makers, the need for development is given primary status.

For example, some of President Raúl Castro's own ideas contribute to describing the country that we wish to have.

- Socialist society, *sustainable* and *prosperous* (*Castro R. Dic. 13, 2012*)
- *Less egalitarian* society, but *more just* (*Castro R. Feb. 24, 2013*)
- The advancement of the economy (*Castro R. Feb. 24, 2013*)
- *Do not leave any citizen unprotected* (*Castro R. Feb. 24, 2013*)

Prioritizing growth to achieve development is also a “relatively new” idea, in contradistinction to the long-held belief that it is possible to develop without growth, and it certainly indicates a much more realistic view of the country's needs for transformation.

Another intangible result is the consensus that to grow Cuba needs to substantially increase its rate of accumulation, and as a consequence, given the strong constraints against further squeezing consumption, it must apply policies that favor and energize foreign direct investment.

In sum, the process of transforming Cuba's economy and society has continued on course, it has led to learning and readjusting some of its components, and has generated appreciable changes in the economy's functioning as well as social stratification, together with recomposition of relations among the State, its institutions and non-state actors. Looking toward 2016, the process will continue to be tense, not only due to financial constraints and macroeconomic distortions, but also because it requires a profound reaccommodation of social and political factors.

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## Chapter 14

# Without Sugarcane There Is No Country. What Should We Do Now?

Pedro Monreal González

The economic foundations for a “post-sugarcane” republic of Cuba is a utopia that is insufficiently imagined, and unfortunately, little discussed. The answer to the crucial question, *What will the country live on?* demands significantly greater attention than it has received to date.

Probably, some will attempt to respond by saying, depending on their point of view, that Cuba “post-sugarcane” will live on tourism, or professional services, or oil exports, or family remittances or the pharmaceutical industry, or a combination of some or all of these things, and perhaps a few more. Even acknowledging that the country has been subsisting, but no more than that, for the past two decades mostly due to the transformation of its international insertion around some of these activities, the primary question remains: What types of exports should Cuba specialize in as part of a comprehensive development strategy?

It should be clear that subsistence does not equal development, nor does the mechanical summation of isolated components amount to a coherent strategy, nor can emergency interventions favored by exceptional diplomatic circumstances replace processes for more stable and consistent structural changes, nor can speculation on (oil) revenues that have not been realized prevail over a lucid assessment of Cuba’s human capital, a resource for achieving development that is a much more important factor than oil.

The question is not very relevant to countries with large internal markets and significant availability of human, financial and material resources. Such countries can “live on” many things since they have economies with a diversity of branches and sectors. For them, international specialization is an option rather than an absolute necessity. But in other cases, such as the Caribbean, island economies have

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always “lived on” a few concrete easily identifiable activities, such as sugarcane for more than 200 years, and more recently, tourism and remittances from family living abroad.

The central dilemma facing every small island economy trying to progress toward development is having to adopt a pattern of productive specialization that is relatively concentrated in a limited number of export activities. This specialization, despite its limitation, assures a beneficial international insertion that leads to the sustainability of expansive reproduction of the economy—the necessary, although insufficient, condition for economic and social development in all countries.

In this type of small economy—and Cuba is exactly that, a small underdeveloped island economy—the limited size of the domestic market, the requirements of economies of scale that characterize contemporary technology, and the limitations of the labor force, financial resources and other means of production, mean that relatively narrow specialization is not simply an option; it is a necessity because small island economies are not capable of establishing a “closed cycle,” i.e., they cannot guarantee at the domestic level everything necessary for economic growth. Under these conditions it is rational to concentrate productive efforts on a small number of export activities (sometimes just a single one) that supports the level of foreign income generation needed to obtain imports that can “close” the cycle. This does not negate the validity of import substitution efforts; rather, import substitution has a relatively secondary role for small island economies where the priority is building a relatively non-diversified but successful export sector.

Initially, Cuba would appear to have adjusted by following a sub-regional pattern of specialization in which sugarcane was replaced in the Caribbean islands by international tourism and remittances. However, a closer look reveals that “post-sugarcane” Cuba has not exactly adjusted to this pattern of sub-regional transformation. First, the so-called “export of professional services,” with all its uncertain sustainability, plays a significant role that is not found in any other Caribbean economy. Additionally, if it were so inclined, given economies of scale and available human capital, Cuba is in a better position than its island neighbors to adopt two fundamental pillars of a development strategy: a relatively more diversified and technologically advanced export profile, and the parallel development of an import substitution process that is comparatively more robust than would be feasible for other islands. Nevertheless, most critical, and most disconcerting, is that while the majority of Caribbean nations have explicit development strategies, generally oriented around tourism, there does not exist—at least publically—an official clearly articulated development strategy for Cuba. There is nothing of the sort.

Obviously, having an official document outlining a development strategy cannot be seen in Cuba or anywhere else as an assurance that the strategy will be applied, much less that it will be successful. Reality is much more complicated, but the absence of such a document, and especially, the lack of an explanation of the development plan can be an important source of social distress. In effect, citizens are not receiving the communication that there is a government plan for “what the country will live on” in the future.



Thirty years ago, the question was answered very quickly, invoking a single word: industrialization. Of course, this was not a categorical response. Industrialization and the “post-sugarcane” future of the Soviet era evaporated in unison with the Council for Mutual Economic Assistance (CMEA) in the late 1980s to early 1990s. That attempt at reconfiguring the country’s international specialization through selective and progressive industrialization seemed to be headed in the right direction given the concrete historical context, but developing a country requires a lot more than a strategic rationale.

The international economic and political frame of reference in which that rationality was embedded failed resoundingly, and everything that was related to it collapsed, including Cuba’s international reorientation. To say now, with the benefit of hindsight, that it was a strategic mistake might be easy, but rather than form a conclusive opinion, it is best viewed as a stimulus for rigorous analysis that considers the centrality of political processes in development strategies.

As for the current national reality, escaping the “abyss” means a lot more for Cuba than variations on subsistence; it requires, above all, a development strategy. Given this absence, restructuring employment, an important component of “updating the model,” could become a serious obstacle to the development process.

“Non-state” economic spaces, with the exception of so-called mixed enterprises and perhaps a segment of agricultural cooperatives, have been viewed principally as spheres of underemployment in which a large portion of the “excess” labor force engages in activities that require technical capacity well below workers’ abilities. The goal is to relocate a considerable number of workers for whom there is no space within state economic accumulation, and who are therefore expelled. One of the supposed positive effects of this would be the eventual increase in productivity and subsequent increase in salaries for workers that manage to stay in the state sector and whose current salaries do not cover the cost of living. In fact, this is an inconsistent assumption because a reduction in labor costs does not provide an adequate basis for sustained increase in productivity. Even more problematic, an eventual improvement in the relative employment conditions in what remains of the state sector must be achieved by degrading employment conditions for the largest portion of the rest of the workforce, which would be transferred to “non-state” underemployment.

The fact that the process includes measures for social protection to cushion the negative impact of labor adjustment does not change the essence of the phenomenon: it is an “industrial reserve army,” a Political Economy term that is more appropriate than “interrupted workers” or “inflated staffs,” caused by the contradictions within state economic accumulation itself, which is condemned to underemployment given the current approach.

Trying to encourage job creation in the twenty-first century from a perspective that privileges job openings as a mechanism for “discharging” state sector costs, assuring at the same time that in practice the alternative promoted is chronic underemployment, does not make sense even as a policy for survival. This is substituting one form of underemployment for another worse one: “inflated staffs” in the state

sector are transformed into employment activities that “deflate” workers’ capacities. The savings in labor costs for the state sector would be achieved at the cost of a monumental waste of the human capital created by the country, a process that invested large amounts of resources generated by the workers themselves. From the perspective of the entire society, which of course goes well beyond the viewpoint of the State’s finances, where would the savings be? What is the sense of devaluing the important investment in human capital in the interest of fixing the accounts of state institutions?

The enormous failure to deploy existing labor capacity and the damage that this will inflict on the potential for technological and organizational innovation are going to end up costing the country’s development efforts sooner rather than later.

As a result of the current economic distortions, an unemployed worker from the state sector with strong technical qualifications can improve individual income working as “self-employed” in any of the authorized commercial activities, usually doing tasks outside of their area of expertise. Any honestly done work deserves respect, social recognition and appropriate reward, and obviously the possibility of improving personal income is convenient from an individual point of view, but the truth is that this can be disastrous for the entire society when this pattern of mostly “pre-industrial” underemployment rapidly expands to thousands of people.

Development consists largely of the capacity to orient the majority of a country’s work force in career paths with increasing technological and organizational learning. These are the careers that add value and strongly contribute to development precisely because they support a more effective utilization of the economic good that is most valuable and scarce: human capital and its intrinsic ability for innovation. Adopting employment policies that favor career paths in the opposite direction leads just about anywhere but to development. This is one of the most valuable lessons that has emerged from the last 100 years of development studies.

It is paradoxical that Cuba is better suited than the other Caribbean islands to adopt a relatively more diversified and technologically advanced export profile, yet it is not able to rapidly and categorically achieve this. From the data on international trade and from the information on investment it could be inferred that Cuba’s international reorientation is based on a relatively limited group of export activities of varied type, some based on natural resources (tourism and mining) and others on human capital, particularly the export of professional services, which accounts for 70 % of the country’s export income, and the pharmaceutical industry. The sustainability of the significant weight of professional services exports (especially health services) could turn out to be less solid than it appears since it relies on the exceptional opportunity offered fundamentally by a single “client.” This opportunity is more of a “diplomatically driven” than a “market-driven” transaction, which could be a very vulnerable foundation for economic reorientation, in much the same way as the earlier experience with the CMEA turned out to be. In contrast, the pharmaceutical industry is probably the most successful and inspiring case of what Cuba can achieve with technological innovation as a driving force for international reinsertion based on innovation.

It is public knowledge that the country's business policies seek to advance the integration of these two export activities (professional health services and pharmaceutical products) and some others, but given the absence of a development strategy in Cuba, it is impossible to know precisely how the country's export reorientation forms part of a comprehensive strategic development plan. It is insufficient to describe export sectors, their eventual dynamics and possible interconnections; rather, it is necessary to concretely outline how, through backward and forward linkages with the rest of the economic structure and the national innovation system, the export sector could drive extensive economic reproduction based on innovation that is ecologically sustainable and socially equitable and inclusive.

The current reorientation approach appears to favor large-scale export schemes, all of which are state-led, or deploy foreign capital in association with the state. However, for a country like Cuba there could be other options available. In principle, the level of human capital suggests the possibility of a more diversified export profile in terms of the type of activities as well as a greater number of export firms, thus reducing the high level of concentration of current exports in a few activities and firms.

The country's highly trained workforce is large, but significant segments are not being utilized, including the human capital that currently resides abroad, unemployed state workers displaced to non-state underemployment, and even workers employed in the state sector that could be more effective outside the state structure. Other than objections anchored in very rigid ideological standards or insufficiently explained political apprehensions, there is no rationale that justifies why extensive "non-state" opportunities have not been established for the country's trained labor force so that it can contribute to diversifying and invigorating the national export sector. This is especially so given that the sector is not only comprised of firms directly involved in exporting; it also includes the so-called export "clusters" involving enterprises that play the important role of maintaining exports through the production chain and by providing services critical to export firms. The role of "entrepreneurs" that drive innovation is critical to export "clusters": this observation has been confirmed by a number of studies of contemporary export processes.

If it has already been accepted as fact that the contradictions of state economic accumulation undermine the deployment of a considerable portion of the trained workforce, why has it not yet been accepted that a fundamental duty of the State is to assure conditions that establish a vibrant non-state sector that encourages full utilization of the capacity and initiative of the country's human capital to stimulate development? If the State were to bring about the transformation of some of the workforce into "entrepreneurs—innovators" within the non-state sector, it would be providing a valuable service to the nation. The analysis of the evidence from around the world is conclusive about the crucial role that "entrepreneurs—innovators" play in development. Denying it is counterproductive.

I shall conclude with a brief note on politics and strategies for development. All of the above analysis cannot be fully understood without a clear assessment of the dominant relationship between politics and scientific-technical rationality in designing and implementing strategies for development.

The “political dimension,” with all its unpredictability and complexity, indeed because of its unpredictability and complexity, is the central factor in development strategies. Politics, economic reforms, and updates to the economic models are not technical events, nor can they be explained precisely, and especially, they cannot be predicted by any social science, including economics. To the contrary, these are all political events in almost the purest sense. The success of the “art” of contending with political realities—and not any a priori established rationality—defines the outcome of these events.

To seriously debate approaches to economic and social development in Cuba, which is what should truly be the paramount objective, it is necessary to accept things as they are: behind the invocation of the nation’s general well-being accompanying the formal proposal of any development strategy—in any country and historical period—there is always a more or less coherent vision that basically reflects the consensus of the social “group” that can “do politics” effectively at a given moment, i.e., that can actualize in reality its concrete interests and impose its notion of how to achieve them. At times this is not exactly related to development and as a consequence does not favor it. Whether this social “group” is a relatively compact community or is made up of various discordant groups that are able to reach agreements is not a minor detail of the politics of development processes. Indeed, political outcomes are a function of relative strength. Moreover, political conflict will always be contradictory by nature although it is not necessarily antagonistic.

The relative decline in state employment in Cuba is creating a set of economic actors (both current and future) with interests that are contradictory to and different from the state sector as well as discordant among the new actors themselves. The eventuality that these dissimilar interests tend to be channeled through politics simply would be the corollary to an economic transformation that spreads to these new actors. Addressing this phenomenon as something “negative,” “concerning,” or “dangerous” might have the effect of slowing it temporarily but will not stop it over the long run. It is preferable to accept it with a view to the future, seeking to take advantage of the positive effect of contradictions in development.

Cuba is rapidly going from being a country of predominantly salaried state workers to becoming something different that is still in the process of formation. What should be avoided is that it being transformed itself into a bifurcated country in which salaried state workers operating in a relatively advanced technological environment coexist with a conglomeration of single producers, small business owners, and private sector workers, most of whom are trapped in a subsistence economy of a “pre-industrial” nature.

Even assuming that the state sector were to bring about a leap in efficiency, something which has yet to be shown to be feasible, it is totally mistaken to further fragment an economic fabric that has already been polarized almost to the extreme and for which the outcome remains unclear (convertible peso vs. Cuban peso, state enterprise vs. corporations). Simply put, the country cannot progress toward development with such a burden.

It is not necessary to reference some political theory to understand what is common sense: a strategy for national development will be socially more inclusive and

more effective to the extent that the representation of social groups actively participating in the development of the strategy is as diverse and contradictory as possible, something that goes beyond the possibility of just being consulted. For example, why not normalize the possibility of incorporating “non-state” entrepreneurs as a fundamental part of institutional deliberations on export diversification?

Understanding that the defense of “non-state” interests can favor national development—not just subsistence—should be part of the process of articulation of an appropriate strategy for the current period as well as for the future. Thus, readjusting the spaces for participation and political discussion will become crucial for the nation’s development. This should also be one of the dimensions of updating the model, which in fact is a single model, since in practice there is no separation between economics and politics. The “economic model” is an analytical and instrumental representation of reality, but it is not reality itself.

These comments come from a political economy perspective, based on abstract concepts that cannot completely reflect the complex social transformation related to the model and the development process. Nevertheless, there is an ethical dimension that should be considered in policies and strategies for change, since at heart they deal with readjustments involving the rights and legitimate aspirations of human beings for a better life for themselves and their families through a job in which they feel self-actualized in Cuba and in these times. Thus, in addition to economic rationality and arguments of political utility, there is also an ethical imperative that supports the necessity of progressing toward renewed mechanisms for participation to facilitate national development.

Development strategies and their implementation do not come from a virtuoso or erudite impulse—as much as the experts and political actors themselves try to sell that idea. Rather, they are the result of contradictory social processes that are decided in the terrain of politics, which can take place in different ways. Preferably, the process of designing the development strategy could include substantial participation on equal footing of all the diversity of economic and social actors in the country. Involving all actors, there will be a better response to the question, *What will the country live on?* No opinion should be a priori considered better than another.

## Chapter 15

# Reflections on the Cuban Model and the Reform Process

Claes Brundenius

### Once Upon a Time There Was a Model...

In the 1980s, the Cuban economic and social model was much in the focus as a success story—at least in terms of income distribution and basic needs satisfaction (food security, health, education, and shelter). I argued in a book (Brundenius 1984) that Cuba was indeed a good example of a growth *with* equity strategy. Furthermore, I was not alone with this assessment. Even the World Bank brought attention to the Cuban success story, through renowned economists such as Hollis Chenery (Chenery et al. 1974) Paul Streeten (Streeten et al. 1981), Dudley Seers and others. However, there were also more critical assessments. Carmelo Mesa-Lago, for instance, although acknowledging the Cuban achievements in a series of social areas, saw the Cuban “model” as an example of “equity trade off for growth” (Mesa-Lago 1986). In other words, such a model would not be viable in the long run since it would have to sacrifice growth in order to achieve the equity goal.

I have always been skeptical about such a blunt rejection of the possibility of combining growth *with* equity in development strategies. However, looking back at the Cuban growth *with* equity performance during the last 25 years, the Cuban economic growth performance would seem to give support to Mesa-Lago’s claim. But still as I have also discussed in other contexts (Brundenius 2002b, 2009). I am not convinced that this is because a growth *with* equity strategy is impossible in any given context. What is clear however is that such a strategy does not work any longer in Cuba, as even Fidel Castro himself seems to have admitted in an interview in 2010. On the other hand, it is also clear that such a strategy worked pretty well in Cuba between approximately 1975 and 1985. It is furthermore a fact that such a model has historically worked in the Nordic countries, and a more recent example is Taiwan.

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## Cuba and Taiwan Revisited

I found Taiwan especially interesting in this context after having read an article by Gary Becker (*Business Week*, 16 June 1986), which discussed the Cuban and Taiwanese development strategies from a growth *with* equity perspective, with my Cuba book (op cit) as a point of departure. Becker argued that although Cuba might be slightly more successful than Taiwan in terms of equity and social indicators, Taiwan combined equity with a much higher sustained rate of growth and efficiency. In a subsequent article (Brundenius 1990) I took a closer look at Taiwan and Cuba in comparative perspective, and found to my surprise that exports in both countries were dominated by sugar in the 1950s and 1960s. A big difference was that while Cuba still by the end of the 1980s was still dependent on sugar (74 %), Taiwan had by that time diversified exports and moved up the value chain, and the share of sugar in exports had declined to less than 1 %.

But the structural changes did not stop here. The Taiwanese state was predominant and playing a leading role in the supply of goods and services during the initial industrialization in the 1950s and 1960s. However, the state's role as a producer declined from 57 % in 1952 to 14 % in 1987. A closer look showed that it was the SMEs that had during the last 30 years been the backbone of economic growth in Taiwan. However, this does not diminish the role of the government as a regulator of the market, and managing the commanding heights of the economy as evidenced by the success stories of East and South East Asia (Wade 1990) (Table 12.1).

Between 1978 and 1986 the Cuban economy grew on a per capita basis at rate of 4.0 % per annum, while the Taiwanese GDP per capita increased at rate of 5.5 %. Up to that point—mid 1980s—Cuba was trailing Taiwan not only in growth terms but Cuba was also doing at least as well in terms of human capital development as Taiwan. But then—around that time—their development paths started diverging. While the Taiwanese per capita growth continued at a rhythm of 4.7 %, the Cuban economy began to stagnate during the end of the 1980s, ending with an economic collapse after the fallout from the demise of the Soviet Union at the beginning of the 1990s, although the Cuban economy started a slow recovery after 1994.

So when Revolutionary Cuba celebrated its 50th anniversary in 2009, it could look back at two quite different periods: The first 25 years could be seen as a success story in many senses—a celebrated growth *with* equity model with impressive social results and satisfaction of many basic needs. However, this success was during the following 25 years succeeded by repeated unstable—and at times disastrous—periods with stumbling growth, deindustrialization, and growing inequalities. However, in the field of most social indicators and above all human capital development Cuba managed to maintain a leading position in the Third World. But as seen in the table this development was not matched by a corresponding growth of the economy.

**Table 12.1** Income levels and human capital in Cuba and Taiwan, 1978–2011

	Cuba		Taiwan			
	GDP/cap PPP USD 2005 prices	Average numbers of years of schooling	Occupied population with 12 years or more of education	GDP/cap PPP USD 2005 prices	Average numbers of years of schooling	Population over 25 years old with 12 years or more of education
1978	6,300	8.1	3.9 %	6,659	5.9	7.4 %
1986	8,634	9.8	8.9 %	10,210	7.6	10.7 %
1998	6,564	10.6	13.7 %	20,840	9.3	19.1 %
2006	10,048	12.4	13.7 %	28,031	10.6	28.9 %
2011	11,831	13.0	18.7 %	32,118	11.4	35.6 %

Sources: GDP/PPP data from Penn Tables (2012); educational attainment data for Cuba: 1978, 1986 and 1998 (Brundenius 2002a), and calculations by the author from *Anuario Estadístico de Cuba* (ONE 2007, 2012); for Taiwan: *Statistical Yearbook of the Republic of China* 1988, 1996 and 2012 (Executive Yuan 1988, 1996, 2012)



## Problems with the Cuban Growth and Accumulation Model

So something went wrong. Why these diverging paths? Why did Taiwan continue its growth *with* equity strategy and why did the Cuban growth *with* equity model get in trouble? Well, the continuing US embargo has certainly been an obstacle for Cuban development efforts. But it is only one contributing factor. The problem is that the model was agonizing already towards the end of the 1980s after stagnation around 1985.

A problem with the Cuban growth performance (not referring to the social model) is that it was dependent on successes and failures in the Soviet Union and Eastern Europe, through its integration in the Council of Mutual Economic Assistance (CMEA), or COMECON as it was called in the West. One could say that when the Soviet Union collapsed it dragged in a way the rest of the members with it (Eastern Europe, Cuba and Vietnam). But the problem was not only rigid and inflexible integration in CMEA, it was also copying of the Soviet planning model. As I have argued in Chap. 8, the *malaise* of the Soviet Planning Model was that it was primarily based on physical targets which should be fulfilled through the expansion of the factors of production (capital and labor), with the economy growing *grosso modo* at the same rate as factor inputs. This *extensive growth model*, in the West often referred to a *factor growth model*, should be seen in contrast to the *intensive growth model*, equivalent of *total factory productivity (TFP)* used in growth models in the West. The main driver in TFP growth is considered to be the *innovative activities* of the firm.

## The Perpetuation of Short Term Solutions

Another problem with the Cuban growth model is that when problems, which are actually structural in nature, have been rectified with measures that may—at best—be justified as short term solutions. Instead such measures have been perpetuated (although perhaps justified and understandable as short term solutions) and gradually over time become long term ad hoc solutions—in expectation of better times? Such an example is the rationing card. There is nothing socialist (or Marxist for that matter) with a rationing card. It could be a temporary and necessary solution to provide a fair distribution of basic goods in times of crises, calamities, or war. However, there is no reason why a country like Cuba should not be able to provide sufficient food for its population after 50 years.

There are two reasons why the rationing did not disappear: The concentration of food production in state farms with lack incentives for the private farmers that were left, and secondly, the perhaps worst mistake, the nationalization of all remaining urban private businesses during the so-called Revolutionary Offensive in March 1968 with nationalization of all remaining SMEs in the country. Instead of solving the goods famine problem this measure perpetuated the rationing card in Cuba.

## Was the 1990s a Lost Decade for Cuba?

Today it is recognized that a non-state sector will play an important role in a new Cuban development strategy. The question then is why it took such a long time?

There was an opening up of the possibility of a private SME sector in 1995. This was in relation to the discussion of the new investment law (Law 77) in the Cuban National Assembly in September 1995. Several deputies considered it an anomaly that Cubans in the *diaspora* were welcome as investors in Cuba while Cubans at home were not. It is interesting that Fidel Castro, when intervening in the debate, said that while there was no law that prohibited Cubans from personally investing in private business one could wonder how an individual could accumulate so much money. For a while the issue of opening up for a private sector (although on a limited scale) continued to be debated openly. But soon the lid was put on, and the debate was closed with the publication of the *Resolución Económica*, adopted at the Fifth Party Congress in 1997 (see also Brundenius 2002b and Brundenius 2009).

That was a pity because Cuba was just recovering from the deep depression and this was an opportunity. Because, as the Chinese say, crises are not only dangerous but they also provide opportunities (“crisis” in Chinese, *wei ji*, stands for the characters “danger+opportunity”). This is also very much in line with Joseph Schumpeter’s *creative destruction*, meaning that it is during crises in the economy (recessions, depressions) that there is increasing room for a swarm of innovations that will replace obsolete structures (Schumpeter 1950).

It is quite clear that if there had been profound structural reforms, like in for instance Vietnam, as we have discussed in this volume, much could have changed for the better much quicker. As a matter of fact there were proposals by party members already in 1995, proposals of reforms (see for instance Carranza et al. 1996) that are only now being considered, and to an increasing extent also being implemented. So in many ways the 1990s with its “Special Period” was a lost decade for Cuba.

## No More Free Lunch?

As the saying goes “there is no free lunch,” that is you cannot get something for nothing in return, and perhaps Cuba is a case in point? As we indicated in the title of this volume: There is “no more free lunch” in sight for the Cuban economy, there is no savior of last resort any more. During the heydays of Cuban growth *with* equity, it is quite obvious that Cuba enjoyed a privileged status in CMEA, especially in its relations to the Soviet Union with its barter agreement sugar for oil. This dependency became evident with the demise of the Soviet Union in 1992 when the superpower broke economic bonds with its former allies practically overnight. This had a disastrous impact on the Cuban economy for many years as has been discussed in this volume.

During the last decade Cuba has also enjoyed privileged status in its relations with Venezuela—that has given the island some space of relief. But how long will this last—now that Hugo Chávez is gone and the future of the Bolivarian Revolution is at stake?

## Can an Outdated Model Be “Updated” or Is Something Radically New Required?

Would it not be better to start elaborating a *new model* that replaces an outdated model? Many scholars of the Cuban economy have recently come up with concrete proposals regarding possible options for a new Cuban model of growth and development, see e.g. Dominguez et al. (2012), Mesa-Lago (2012) and Mesa-Lago and Pérez-López (2013). Back in 2001 I and Pedro Monreal sketched on some scenarios for the Cuban economy in a chapter in a book (Brundenius and Monreal 2001). One important conclusion was that, unless there would turn up some spectacular new sources of income (like huge off shore oil deposits), Cuba must become an *innovator* and provide *incentives* for its citizens to be innovative. This is increasingly becoming an imperative with a declining labor force due to an aging population and low fertility rate (ONE 2009). This does not necessarily mean a return to the spectre of capitalism. There are different shades of capitalism, as well as there are different shades of socialism. Market economy can function in capitalism as well as it can in socialism as recognized by scholars such as Joseph Schumpeter (1950), Nove (1983) and Joseph Stiglitz (1994).

But it is a bit ironic that whilst we talk about the crisis of the socialist model in Cuba, capitalism worldwide is undergoing its deepest crisis since the Great Depression with growing inequalities worldwide (Stiglitz 2010, 2012; Galbraith 2012). But clearly, capitalism is not “the end of history” and it is now more than ever important to search for alternative models that can combine the efficiency of competitive and efficient market models with environmental sustainability combined with equity, solidarity, and democracy. Cooperative models could be an important part of such solutions as discussed in this volume.

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